1986

Uniform CPA Examination, May 1981-May 1985, Selected Questions & Unofficial Answers Indexed To Content Specification Outlines

American Institute of Certified Public Accountants. Board of Examiners

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Uniform CPA Examination
May 1981 - May 1985

Selected Questions & Unofficial Answers
Indexed To Content Specification Outlines

Accounting Practice
Accounting Theory
Auditing
Business Law

AICPA
American Institute of Certified Public Accountants
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 1985 back to May 1981. 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 (81 through 85), 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 essay question is indexed according to the area it tests and in certain cases to the group it tests. Where essay questions and their answers involve more than one part—for example, part a. and part b.—the essays 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 1985 Uniform CPA Examination are included at the end of each of the four examination sections, i.e., Accounting Practice, Accounting Theory, Auditing, and Business Law. Following each section's questions and unofficial answers is an index of the section's questions which classifies them in accordance with the 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.

William C. Bruschi, Vice President—Regulation
American Institute of Certified Public Accountants

January 1986
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And Unofficial Answers
Indexed To
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edited by
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David S. Dexter
Technical Manager, Examinations Division
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†Questions in this area are not classified according to group.
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MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Presentation of Financial Statements or Worksheets

C. Statement of Changes in Financial Position

**Best Corporation**

**INCOME STATEMENTS**

*Year ended December 31, 1982*

<table>
<thead>
<tr>
<th>Credit sales</th>
<th>$6,300,000</th>
<th>$4,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>4,900,000</td>
<td>3,200,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,400,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Expenses (including income taxes)</td>
<td>$700,000</td>
<td>$630,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$700,000</td>
<td>$170,000</td>
</tr>
</tbody>
</table>

**BALANCE SHEETS**

<table>
<thead>
<tr>
<th>December 31,</th>
<th>1982</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total current assets</td>
<td>2,080,000</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>1,120,000</td>
<td>650,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$3,200,000</td>
<td>$1,900,000</td>
</tr>
<tr>
<td>Liabilities and stockholders’ equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>1,170,000</td>
<td>570,000</td>
</tr>
<tr>
<td>Stockholders’ equity:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, 1/1</td>
<td>$900,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Sold, 4/1/82</td>
<td>100,000</td>
<td>—</td>
</tr>
<tr>
<td>20% stock dividend, 6/1/82</td>
<td>200,000</td>
<td>—</td>
</tr>
<tr>
<td>Balance, 12/31</td>
<td>$1,200,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, 1/1</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Sold, 4/1/82</td>
<td>25,000</td>
<td>—</td>
</tr>
<tr>
<td>20% stock dividend, 6/1/82</td>
<td>75,000</td>
<td>—</td>
</tr>
<tr>
<td>Balance, 12/31</td>
<td>$200,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, 1/1</td>
<td>$330,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Net income</td>
<td>700,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Cash dividends</td>
<td>(125,000)</td>
<td>(90,000)</td>
</tr>
<tr>
<td>Stock dividends</td>
<td>(275,000)</td>
<td>—</td>
</tr>
<tr>
<td>Balance, 12/31</td>
<td>$630,000</td>
<td>$330,000</td>
</tr>
</tbody>
</table>

Additional available information included the following:

- Although Best will report all changes in financial position, management has adopted a format emphasizing the flow of working capital.
• During 1982, Best sold, at a $10,000 loss, fixtures with a book value of $30,000 ($100,000 cost minus $70,000 accumulated depreciation). This loss was included in the income statement. Depreciation expense for 1982 was $130,000. Best purchased $630,000 of new fixtures during 1982.

• Common stock issued during 1982 was as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Number of shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/1/82</td>
<td>10,000</td>
</tr>
<tr>
<td>6/1/82</td>
<td>20,000</td>
</tr>
</tbody>
</table>

24. How much working capital provided by operations during 1982 should be reported in the statement of changes in financial position?
   a. $300,000
   b. $700,000
   c. $830,000
   d. $840,000

25. How much working capital was provided by the sale of common stock during 1982?
   a. $100,000
   b. $125,000
   c. $200,000
   d. $400,000

26. How much working capital was used for dividends during 1982?
   a. $85,000
   b. $125,000
   c. $325,000
   d. $400,000

1NB1#18. Selected information from Brook Corporation’s accounting records and financial statements for 1980 is as follows:

Working capital provided by operations $1,500,000
Mortgage payable issued to acquire land and building 1,800,000
Common stock issued to retire preferred stock 500,000
Proceeds from sale of equipment 400,000
Cost of office equipment purchased 200,000

On the statement of changes in financial position for the year ended December 31, 1980, Brook should disclose total sources of funds in the amount of
   a. $1,700,000
   b. $2,400,000
   c. $3,700,000
   d. $4,200,000

1NB1#20. The net income for Mountain Corporation was $4,000,000 for the year ended December 31, 1980. Additional information is as follows:

Depreciation on fixed assets $2,000,000
Provision for doubtful accounts on short-term receivables 200,000
Provision for doubtful accounts on long-term receivables 300,000
Dividends on preferred stock 400,000

The working capital provided from operations in the statement of changes in financial position for the year ended December 31, 1980, should be:
   a. $4,900,000
   b. $6,000,000
   c. $6,300,000
   d. $6,500,000

2NB1

Items 25 through 28 relate to data to be reported in the Statement of Changes in Financial Position of Debbie Dress Shops, Inc., based on the following information:

Debbie Dress Shops, Inc.
BALANCE SHEETS

<table>
<thead>
<tr>
<th></th>
<th>December 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1980</td>
</tr>
</tbody>
</table>

| Assets                | 1980         | 1979         |
|-----------------------|--------------|
| Current assets:       |              |              |
| Cash                  | $300,000     | $200,000     |
| Accounts receivable   |              |              |
| — net                 | 840,000      | 580,000      |
| Merchandise inventory | 660,000      | 420,000      |
| Prepaid expenses      | 100,000      | 50,000       |
| Total current assets  | 1,900,000    | 1,250,000    |
| Long-term investments | 80,000       | —            |
| Land, buildings, and  |              |              |
| fixtures              | 1,130,000    | 600,000      |
| Less accumulated      |              |              |
| depreciation          | 110,000      | 50,000       |
| Total assets          | 3,000,000    | 1,800,000    |

| Equities              |              |              |
| Current liabilities:  |              |              |
| Accounts payable      | $530,000     | $440,000     |
| Accrued expenses      | 140,000      | 130,000      |
| Dividends payable     | 70,000       | —            |
| Total current liabilities | 740,000 | 570,000     |
| Note payable — due 1983 | 500,000     | —            |

Stockholders’ equity:
| Common stock         | 1,200,000    | 900,000      |
| Retained earnings    | 560,000      | 330,000      |
| Total stockholders’ equity | 1,760,000 | 1,230,000   |

Total liabilities and stockholders’ equity $3,000,000 $1,800,000

AP-2
SELECTED QUESTIONS

Debbie Dress Shops, Inc.
INCOME STATEMENTS

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>1980</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net credit sales</td>
<td>$6,400,000</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>5,000,000</td>
<td>3,200,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,400,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Expenses (including income taxes)</td>
<td>1,000,000</td>
<td>520,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 400,000</td>
<td>$ 280,000</td>
</tr>
</tbody>
</table>

Additional information available included the following:

- Although the Corporation will report all changes in financial position, management has adopted a format emphasizing the flow of cash.
- All accounts receivable and accounts payable relate to trade merchandise. Accounts payable are recorded net and always are paid to take all of the discount allowed. The Allowance for Doubtful Accounts at the end of 1980 was the same as at the end of 1979; no receivables were charged against the Allowance during 1980.
- The proceeds from the note payable were used to finance a new store building. Capital stock was sold to provide additional working capital.

25. Cash collected during 1980 from accounts receivable amounted to
   a. $5,560,000
   b. $5,840,000
   c. $6,140,000
   d. $6,400,000

26. Cash payments during 1980 on accounts payable to suppliers amounted to
   a. $4,670,000
   b. $4,910,000
   c. $5,000,000
   d. $5,150,000

27. Cash receipts during 1980 which were not provided by operations totaled
   a. $140,000
   b. $300,000
   c. $500,000
   d. $800,000

28. Cash payments for noncurrent assets purchased during 1980 were
   a. $ 80,000
   b. $530,000
   c. $610,000
   d. $660,000

Magnolia, Inc.
BALANCE SHEETS

<table>
<thead>
<tr>
<th>December 31,</th>
<th>1980</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 474,000</td>
<td>$ 320,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>1,230,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(436,000)</td>
<td>(420,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>480,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,748,000</td>
<td>$1,600,000</td>
</tr>
</tbody>
</table>

You have discovered the following facts:

- During 1980, Magnolia sold at no gain or loss equipment with a book value of $76,000 and purchased new equipment costing $150,000.

- During 1980, bonds with a face and book value of $200,000 were extinguished, with no gain or loss. They were not current liabilities prior to their extinguishment.

- Retained earnings was affected only by the 1980 net income or loss.

29. How much working capital was provided by operations during 1980?
   a. $208,000
   b. $212,000
   c. $220,000
   d. $228,000

30. Assume that $200,000 face value of bonds became current at December 31, 1980, to be repaid in early 1981. What should be the change in working capital under this assumption after considering all changes in financial position?
   a. $ 46,000 increase.
   b. $ 46,000 decrease.
   c. $246,000 increase.
   d. $246,000 decrease.
II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

1M85#1. Fay Company had the following bank reconciliation at March 31, 1985:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per bank statement, 3/31/85</td>
<td>$23,250</td>
</tr>
<tr>
<td>Add deposit in transit</td>
<td>5,150</td>
</tr>
<tr>
<td>Less outstanding checks</td>
<td>6,300</td>
</tr>
<tr>
<td>Balance per books, 3/31/85</td>
<td>$22,100</td>
</tr>
</tbody>
</table>

Data per bank for the month of April 1985 follows:

- Deposits: $29,200
- Disbursements: $24,850

All reconciliation items at March 31, 1985, cleared through the bank in April. Outstanding checks at April 30, 1985, totaled $3,500. What is the balance of cash per books at April 30, 1985?
- a. $31,100
- b. $26,450
- c. $24,100
- d. $22,950

1M85#2. Butler Company had the following portfolio of current marketable equity securities at December 31, 1984:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$40,000</td>
<td>$41,000</td>
</tr>
<tr>
<td>B</td>
<td>70,000</td>
<td>66,000</td>
</tr>
</tbody>
</table>

In Butler's December 31, 1984, balance sheet, the carrying value of the portfolio should be reported at
- a. $106,000
- b. $107,000
- c. $110,000
- d. $111,000

1M85#3. On April 1, 1984, Aldrich Company purchased as a temporary investment $200,000 face value, 9% U.S. Treasury notes for $198,500, which includes accrued interest of $4,500. The notes mature July 1, 1985, and pay interest semiannually on January 1 and July 1. The notes were sold on December 1, 1984, for $206,500, which includes accrued interest of $7,500. In its income statement for the year ended December 31, 1984, what amount should Aldrich report as a gain on sale of marketable securities?
- a. $1,800
- b. $5,000
- c. $6,500
- d. $8,000

1M85#4. On July 1, 1984, Ward Company purchased 500 of the $1,000 face value, 8% bonds of Drury Corporation for $461,400 to yield 10% per annum. The bonds, which mature on July 1, 1989, pay interest semiannually on January 1 and July 1. Ward uses the interest method of amortization and the bonds are appropriately recorded as a long-term investment. The bonds should be reported on Ward's December 31, 1984, balance sheet at
- a. $458,330
- b. $464,470
- c. $467,540
- d. $496,930

1N84#1. During 1982 Brody Company purchased marketable equity securities as a short-term investment. At December 31, 1982, the balance in the allowance for decline in value of current marketable equity securities was $20,000. There were no security transactions during 1983. Pertinent data at December 31, 1983, are as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>$210,000</td>
<td>$190,000</td>
</tr>
<tr>
<td>Y</td>
<td>185,000</td>
<td>207,000</td>
</tr>
<tr>
<td>Z</td>
<td>100,000</td>
<td>90,000</td>
</tr>
<tr>
<td></td>
<td>$495,000</td>
<td>$487,000</td>
</tr>
</tbody>
</table>

In its 1983 income statement, Brody should report (an)
- a. Recovery of unrealized loss of $12,000.
- b. Unrealized loss of $12,000.
- c. Recovery of unrealized loss of $10,000.
- d. Unrealized loss of $8,000.

1N84#2. On January 3, 1983, Mill, Inc., acquired 20% of the outstanding common stock of Nash Company for $700,000. This investment gave Mill the ability to exercise significant influence over Nash. The book value of the acquired shares was $600,000. The excess of cost over book value was attributed to an identifiable intangible asset which was undervalued on Nash's balance sheet and which had a remaining useful life of ten years. For the year ended December 31, 1983, Nash reported net income of $180,000 and paid cash dividends of $60,000 on its common stock. At December 31, 1983, the carrying value of Mill's investment in Nash should be
- a. $678,000
- b. $690,000
- c. $700,000
- d. $714,000
Selected Questions

1M84#1. On December 31, 1982, Clark Company purchased marketable equity securities as a temporary investment. Pertinent data are as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market value at 12/31/83</th>
</tr>
</thead>
<tbody>
<tr>
<td>W</td>
<td>$24,000</td>
<td>$26,000</td>
</tr>
<tr>
<td>X</td>
<td>36,000</td>
<td>33,000</td>
</tr>
<tr>
<td>Y</td>
<td>72,000</td>
<td>65,000</td>
</tr>
</tbody>
</table>

On December 31, 1983, Clark reclassified its investment in security Y from current to noncurrent because Clark intends to retain security Y as a long-term investment. What total amount of loss on these securities should be included in Clark's income statement for the year ended December 31, 1983?

a. $0
b. $1,000
c. $7,000
d. $8,000

1M84#2. Tallent Corporation had the following account balances at December 31, 1983:

- Cash on hand and in banks: $975,000
- Cash legally restricted for additions to plant (expected to be disbursed in 1985): 600,000
- Bank certificates of deposit (due February 1, 1984): 250,000

In the current assets section of Tallent’s December 31, 1983, balance sheet, what total amount should be reported under the caption “cash and cash equivalents”?

a. $975,000
b. $1,225,000
c. $1,575,000
d. $1,825,000

1M84#3. On January 1, 1983, Wright Company purchased Keeler Corporation 9% bonds with a face value of $200,000, for $187,800. The bonds were purchased to yield 10%. The bonds are dated January 1, 1983, mature on December 31, 1992, and pay interest annually on December 31. Wright uses the interest method of amortizing bond discount. In its income statement for the year ended December 31, 1983, what total amount should Wright report as interest income from the long-term bond investment?

a. $17,220
b. $18,000
c. $18,780
d. $20,000

1M84#4. On January 1, 1983, Miller Company purchased 25% of Wall Corporation’s common stock; no goodwill resulted from the purchase. Miller appropriately carries this investment at equity and the balance in Miller’s investment account was $190,000 at December 31, 1983. Wall reported net income of $120,000 for the year ended December 31, 1983, and paid common stock dividends totaling $48,000 during 1983. How much did Miller pay for its 25% interest in Wall?

a. $172,000
b. $202,000
c. $208,000
d. $232,000

1M83#2. During 1982, Anthony Company purchased marketable equity securities as a long-term investment. Pertinent data are as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market value at 12/31/82</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$20,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>B</td>
<td>40,000</td>
<td>30,000</td>
</tr>
<tr>
<td>C</td>
<td>90,000</td>
<td>93,000</td>
</tr>
<tr>
<td></td>
<td>$150,000</td>
<td>$141,000</td>
</tr>
</tbody>
</table>

Anthony appropriately carries these securities at the lower of aggregate cost or market value. The amount of unrealized loss on these securities to flow through Anthony’s income statement for 1982 should be

a. $0
b. $3,000
c. $9,000
d. $12,000

1M83#3. On January 1, 1982, Weaver Company purchased as a long-term investment $500,000 face value of Park Corporation’s 8% bonds for $456,200. The bonds were purchased to yield 10% interest. The bonds mature on January 1, 1988, and pay interest annually on January 1. Weaver uses the interest method of amortization. What amount should Weaver report on its December 31, 1982, balance sheet as long-term investment?

a. $450,580
b. $456,200
c. $461,820
d. $466,200

1M83#20. Greenfield Company had the following cash balances at December 31, 1982:

- Cash in banks: $1,500,000
- Petty cash funds (all funds were reimbursed on December 31, 1982): $20,000
- Cash legally restricted for additions to plant (expected to be disbursed in 1984): $2,000,000

Cash in banks includes $500,000 of compensating balances against short-term borrowing arrangements at December 31, 1982. The compensating balances are not
legally restricted as to withdrawal by Greenfield. In the current assets section of Greenfield's December 31, 1982, balance sheet, what total amount should be reported as cash?

   a. $1,020,000  
   b. $1,520,000  
   c. $3,020,000  
   d. $3,520,000

2M83#10. Denso Corporation reports on a calendar-year basis. Its December 31, 1982, financial statements were issued on February 3, 1983. The auditor's report was dated January 22, 1983. The following information pertains to Denso's aggregate marketable equity securities portfolio:

<table>
<thead>
<tr>
<th></th>
<th>$500,000</th>
<th>400,000</th>
<th>350,000</th>
<th>300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market value, 12/31/82</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market value, 1/22/83</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market value, 2/3/83</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

How much should be reported on Denso's balance sheet at December 31, 1982, for marketable equity securities?

   a. $500,000  
   b. $400,000  
   c. $350,000  
   d. $300,000

1M82#2. On January 1, 1976, Darby Company purchased, at par, 500 of the $1,000 face value, 8% bonds of Clark Corporation as a long-term investment. The bonds mature on January 1, 1986, and pay interest semiannually on July 1 and January 1. Clark incurred heavy losses from operations for several years and defaulted on the July 1, 1980, and January 1, 1981, interest payments. Because of the permanent decline in market value of Clark's bonds, Darby wrote down its investment to $400,000 at December 31, 1980. Pursuant to Clark's plan of reorganization effected on July 1, 1981, Darby received 5,000 shares of $100 par value, 8% cumulative preferred stock of Clark in exchange for the $500,000 face value bond investment. The quoted market value of the preferred stock was $70 per share on July 1, 1981. What amount of loss should be included in the determination of Darby's net income for 1981?

   a. $0  
   b. $50,000  
   c. $100,000  
   d. $150,000

1M82#6. In preparing its bank reconciliation for the month of March 1982, Derby Company has available the following information:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per bank statement, 3/31/82</td>
<td>$36,050</td>
</tr>
<tr>
<td>Deposit in transit, 3/31/82</td>
<td>6,250</td>
</tr>
<tr>
<td>Outstanding checks, 3/31/82</td>
<td>5,750</td>
</tr>
<tr>
<td>Credit erroneously recorded by bank</td>
<td></td>
</tr>
<tr>
<td>in Derby's account, 3/12/82</td>
<td>250</td>
</tr>
<tr>
<td>Bank service charges for March</td>
<td>50</td>
</tr>
</tbody>
</table>

What should be the correct balance of cash at March 31, 1982?

   a. $35,250  
   b. $36,250  
   c. $36,300  
   d. $36,550

2M82#2. On January 2, 1981, Portela, Inc., bought 30% of the outstanding common stock of Bracero Corporation for $258,000 cash. Portela accounts for this investment by the equity method. At the date of acquisition of the stock, Bracero's net assets had a book and fair value of $620,000. The excess of Portela's cost of the investment over its share of Bracero's net assets has an estimated life of 40 years. Bracero's net income for the year ended December 31, 1981, was $180,000. During 1981, Bracero declared and paid cash dividends of $20,000. On December 31, 1981, Portela should have carried its investment in Bracero in the amount of

   a. $234,000  
   b. $258,000  
   c. $304,200  
   d. $306,000

2M82#10. On January 2, 1980, Troquel Corporation bought 15% of Zafacon Corporation's capital stock for $30,000. Troquel accounts for this investment by the cost method. Zafacon's net income for the years ended December 31, 1980, and December 31, 1981, were $10,000 and $50,000 respectively. During 1981, Zafacon declared a dividend of $70,000. No dividends were declared in 1980. How much should Troquel show on its 1981 income statement as income from this investment?

   a. $1,575  
   b. $7,500  
   c. $9,000  
   d. $10,500
2N82#12. In January 1979, Cameron Corporation established a sinking fund in connection with its issue of bonds due in 1989. A bank was appointed as independent trustee of the fund. At December 31, 1981, the trustee held $364,000 cash in the sinking fund account, representing $300,000 in annual deposits to the fund, and $64,000 of interest earned on those deposits. How should the sinking fund be reported in Cameron’s balance sheet at December 31, 1981?

a. No part of the sinking fund should appear in Cameron’s balance sheet.
b. $64,000 should appear as a current asset.
c. $364,000 should appear as a current asset.
d. $364,000 should appear as a noncurrent asset.

1N81#3. On July 1, 1980, Hilltop Company purchased as a long-term investment Essex Company’s ten-year 9% bonds, with a face value of $100,000 for $95,200. Interest is payable semiannually on January 1 and July 1. The bonds mature on July 1, 1984. Hilltop uses the straight-line method of amortization. What is the amount of interest income and amortization of bond discount that Hilltop should report in its income statement for the year ended December 31, 1980?

a. $4,284 and $240.
b. $4,284 and $600.
c. $4,500 and $240.
d. $4,500 and $600.

2N81#2. Lee Corporation’s checkbook balance on December 31, 1980, was $4,000. In addition, Lee held the following items in its safe on December 31:

Check payable to Lee Corporation, dated January 2, 1981, not included in December 31 checkbook balance $1,000

Check payable to Lee Corporation, deposited December 20, and included in December 31 checkbook balance, but returned by bank on December 30, stamped “NSF.” The check was re-deposited January 2, 1981, and cleared January 7 200

Postage stamps received from mail-order customers 75

Check drawn on Lee Corporation’s account, payable to a vendor, dated and recorded December 31, but not mailed until January 15, 1981 500

The proper amount to be shown as Cash on Lee’s balance sheet at December 31, 1980, is

a. $3,800
b. $4,000
c. $4,300
d. $4,875

2N81#7. In 1980, Wallace Corporation purchased marketable securities, and at December 31, 1980, had the following marketable equity securities:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market</th>
<th>Unrealized gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>$80,000</td>
<td>$50,000</td>
<td>$(30,000)</td>
</tr>
<tr>
<td>Y</td>
<td>15,000</td>
<td>20,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Total $95,000 $70,000 $(25,000)

In Noncurrent Assets:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market</th>
<th>Unrealized gain (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q</td>
<td>60,000</td>
<td>70,000</td>
<td>10,000</td>
</tr>
<tr>
<td>R</td>
<td>90,000</td>
<td>45,000</td>
<td>(45,000)</td>
</tr>
</tbody>
</table>

Total $150,000 $115,000 $(35,000)

Valuation allowances at December 31, 1980, should be established with a corresponding charge against stockholders’ equity:

<table>
<thead>
<tr>
<th>Income</th>
<th>Stockholders’ equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 0</td>
<td>$60,000</td>
</tr>
<tr>
<td>b. 25,000</td>
<td>0</td>
</tr>
<tr>
<td>c. 25,000</td>
<td>35,000</td>
</tr>
<tr>
<td>d. 60,000</td>
<td>0</td>
</tr>
</tbody>
</table>

2N81#11. On January 1, 1980, Rey Corporation paid $150,000 for 10,000 shares of Rio Corporation’s common stock, representing a 15% investment in Rio. Rio declared and paid a dividend of $1 a share to its common stockholders during 1980. Rio’s net income was $130,000 for the year ended December 31, 1980. At what amount should Rey’s investment in Rio appear on Rey’s balance sheet as of December 31, 1980?

a. $140,000
b. $150,000
c. $159,500
d. $169,500

B. Receivables and Accruals

1N85#5. An analysis and aging of the accounts receivable of Grey Company at December 31, 1984, revealed the following data:

<table>
<thead>
<tr>
<th>Accounts receivable</th>
<th>$900,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for uncollectible accounts per books</td>
<td>50,000</td>
</tr>
<tr>
<td>Amounts deemed uncollectible</td>
<td>64,000</td>
</tr>
</tbody>
</table>

The net realizable value of the accounts receivable at December 31, 1984, should be

a. $886,000
b. $850,000
c. $836,000
d. $786,000
1M85#6. On August 1, 1984, Kern Company leased a machine to Day Company for a six-year period requiring payments of $10,000 at the beginning of each year. The machine cost $48,000, which is the fair value at the lease date, and has a useful life of eight years with no residual value. Kern's implicit interest rate is 10% and present value factors are as follows:

Present value of an annuity due of $1 at 10% for 6 periods 4.791
Present value of an annuity due of $1 at 10% for 8 periods 5.868

Kern appropriately recorded the lease as a direct financing lease. At the inception of the lease, the gross lease receivables account balance should be

a. $60,000
b. $58,680
c. $48,000
d. $47,910

1M85#7. Pine Company provides for doubtful accounts expense at the rate of 2% of credit sales. The following data are available for 1984:

Allowance for doubtful accounts, 1/1/84 $18,000
Accounts written off as uncollectible during 1984 20,000
Collection of accounts written off in prior years (customer credit was reestablished) 5,000
Credit sales year ended 12/31/84 1,500,000

The allowance for doubtful accounts balance at December 31, 1984, should be

a. $33,000
b. $30,600
c. $28,000
d. $15,000

1M85#9. Weaver, Inc., received a $60,000, six-month, 12% interest-bearing note from a customer. The note was discounted the same day at Third National Bank at 15%. The amount of cash received by Weaver from the bank was

a. $64,770
b. $63,600
c. $59,100
d. $58,830

All merchandise is marked to sell at 40% above cost. Assume that all sales are credit sales and all receivables are collectible. The balance in accounts receivable at December 31, 1983, should be

a. $160,000
b. $244,000
c. $300,000
d. $384,000

1N84#4. Russell, Inc., owns 80% of the outstanding capital stock of Cox Corporation. On November 1, 1983, Russell advanced $100,000 in cash to Cox. In the December 31, 1983, consolidated balance sheet, the advance should be reported at

a. $0
b. $20,000
c. $80,000
d. $100,000

1N84#5. All of Glenn's sales are on a credit basis. The following information is available for 1983:

| Allowance for doubtful accounts, 1/1/83 | $18,000 |
| Sales | 950,000 |
| Sales returns | 80,000 |
| Accounts written off as uncollectible, 11/30/83 | 20,000 |

Glenn provides for doubtful accounts expense at the rate of 3% of net sales. At December 31, 1983, the allowance for doubtful accounts balance should be

a. $28,100
b. $26,500
c. $26,100
d. $24,100

1N83#19. Grant, Inc., has current receivables from affiliated companies at December 31, 1982, as follows:

- A $50,000 cash advance to Adams Corporation. Grant owns 30% of the voting stock of Adams and accounts for the investment by the equity method.
- A receivable of $160,000 from Bullard Corporation for administrative and selling services. Bullard is 100% owned by Grant and is included in Grant's consolidated statements.
- A receivable of $100,000 from Carpenter Corporation for merchandise sales on open account. Carpenter is a 90% owned, unconsolidated subsidiary of Grant.

In the current assets section of its December 31, 1982, consolidated balance sheet, Grant should report accounts receivable from investees in the total amount of

a. $90,000
b. $140,000
c. $150,000
d. $310,000

1N84#3. Lewis Company began operations on January 1, 1983. The following information is available for the year ended December 31, 1983:

| Total merchandise purchases | $700,000 |
| Merchandise inventory at 12/31/83 | 140,000 |
| Collections from customers | 400,000 |
1MB3#21. Barrett Company's account balances at December 31, 1982, for accounts receivable and the related allowance for doubtful accounts were $1,200,000 and $60,000, respectively. An aging of accounts receivable indicated that $106,000 of the December 31, 1982, receivables may be uncollectible. The net realizable value of accounts receivable was
   a. $1,034,000
   b. $1,094,000
   c. $1,140,000
   d. $1,154,000

1MB3#22. Anderson Company accepted a $20,000, 90-day, 12% interest-bearing note dated September 15, 1982, from a customer. On October 15, 1982, Anderson discounted the note at Provident National Bank at a 15% discount rate. The customer paid the note at maturity. Based on a 360-day year, what amount should Anderson report as net interest revenue from the note transaction?
   a. $85
   b. $100
   c. $150
   d. $200

1MB2#3. Tillary Company, which began business on January 1, 1981, appropriately uses the installment sales method of accounting. The following data are available for 1981:

Installment accounts receivable,
December 31, 1981 $200,000
Deferred gross profit, December 31, 1981 (before recognition of realized gross profit) $140,000
Gross profit on sales 40%

The cash collections and the realized gross profit on installment sales for the year ended December 31, 1981, should be

<table>
<thead>
<tr>
<th>Cash collections</th>
<th>Realized gross profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $100,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>b. $100,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>c. $150,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>d. $150,000</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

1MB2#4. Based upon its past collection experience, Tallent Company received a $30,000, 6-month, 10% interest-bearing note from a customer. After holding the note for two months, Tallent was in need of cash and discounted the note at the United National Bank at a 12% discount rate. The amount of cash received by Tallent from the bank was
   a. $31,260
   b. $30,870
   c. $30,300
   d. $30,240

1MB2#18. On December 31, 1979, Marsh Company entered into a debt restructuring agreement with Saxe Company, which was experiencing financial difficulties. Marsh restructured a $100,000 note receivable as follows:

- Reduced the principal obligation to $70,000.
- Forgive $12,000 of accrued interest.
- Extended the maturity date from December 31, 1979, to December 31, 1981.
- Reduced the interest rate from 12% to 8%. Interest was payable annually on December 31, 1980, and 1981.

In accordance with the agreement, Saxe made payments to Marsh on December 31, 1980, and 1981. How much interest income should Marsh report for the year ended December 31, 1981?
   a. $0
   b. $5,600
   c. $8,400
   d. $11,200

AP-9
2N81#1. The following accounts were abstracted from the December 31, 1980, trial balance of Robby Company:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit sales</td>
<td></td>
<td>$750,000</td>
</tr>
<tr>
<td>Sales discounts</td>
<td>$15,000</td>
<td></td>
</tr>
</tbody>
</table>

On January 1, 1980, Allowance for Doubtful Accounts had a credit balance of $18,000. During 1980, $30,000 of uncollectible accounts receivable were written off. Past experience indicates that 3% of gross sales prove to be uncollectible. What should be the balance of Allowance for Doubtful Accounts at December 31, 1980, after provision is made for the current year?

a. $10,050  
b. $10,500  
c. $22,050  
d. $34,500

2N81#8. Marmol Corporation uses the allowance method for bad debts. During 1980, Marmol charged $30,000 to bad debt expense, and wrote off $25,200 of uncollectible accounts receivable. These transactions resulted in a decrease in working capital of

a. $0  
b. $4,800  
c. $25,200  
d. $30,000

2N81#17. Bibi Corporation owns 80% of the outstanding capital stock of Daniels Corporation. On July 1, 1980, Bibi advanced $50,000 in cash to Daniels. On the consolidated balance sheet at December 31, 1980, how much of the advance should be eliminated?

a. $0  
b. $10,000  
c. $40,000  
d. $50,000

2M81#19. Steven Corporation began operations in 1980. For the year ended December 31, 1980, Steven made available the following information:

- Total merchandise purchases for the year: $350,000
- Merchandise inventory at December 31, 1980: 70,000
- Collections from customers: 200,000

All merchandise was marked to sell at 40% above cost. Assuming that all sales are on a credit basis and all receivables are collectible, what should be the balance in accounts receivable at December 31, 1980?

a. $50,000  
b. $192,000  
c. $250,000  
d. $290,000

C. Inventories

1M85#8. Hall Company's inventory at December 31, 1984, was $1,500,000 based on a physical count of goods priced at cost, and before any necessary year-end adjustment relating to the following:

- Included in the physical count were goods billed to a customer F.O.B. shipping point on December 31, 1984. These goods had a cost of $30,000 and were picked up by the carrier on January 10, 1985.
- Goods shipped F.O.B. shipping point on December 28, 1984, from a vendor to Hall were received on January 4, 1985. The invoice cost was $50,000.

What amount should Hall report as inventory on its December 31, 1984, balance sheet?

a. $1,470,000  
b. $1,480,000  
c. $1,520,000  
d. $1,550,000

1M85#10. Marsh Company had 150 units of product A on hand at January 1, 1985, costing $21 each. Purchases of product A during the month of January were as follows:

<table>
<thead>
<tr>
<th>Units</th>
<th>Unit cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 10</td>
<td>200</td>
</tr>
<tr>
<td>18</td>
<td>250</td>
</tr>
<tr>
<td>28</td>
<td>100</td>
</tr>
</tbody>
</table>

A physical count on January 31, 1985, shows 250 units of product A on hand. The cost of the inventory at January 31, 1985, under the LIFO method is

a. $5,850  
b. $5,550  
c. $5,350  
d. $5,250

and the multiple-pools approach. The following data were available for Inventory Pool No. 1 for the two years following the adoption of LIFO:

<table>
<thead>
<tr>
<th>Current inventory</th>
<th>Internal price</th>
<th>Internal price</th>
</tr>
</thead>
<tbody>
<tr>
<td>At current year cost</td>
<td>At base year cost</td>
<td>Index</td>
</tr>
<tr>
<td>1/1/83</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>12/31/83</td>
<td>126,000</td>
<td>120,000</td>
</tr>
<tr>
<td>12/31/84</td>
<td>140,800</td>
<td>128,000</td>
</tr>
</tbody>
</table>

Under the dollar value LIFO method the inventory at December 31, 1984, should be

a. $128,000
b. $129,800
c. $130,800
d. $140,800

1M84#6. Thomson Company had the following consignment transactions during December 1983:

Inventory shipped on consignment to
Pavin Company, consignee $3,000
Freight paid by Thomson 100

Inventory received on consignment from
Bellin Company, consignor 5,000
Freight paid by Bellin 300

No sales of consigned goods were made through December 31, 1983.

In its December 31, 1983, balance sheet, Thomson should include consigned inventory of

a. $8,400
b. $8,000
c. $3,100
d. $3,000

1M84#7. At December 31, 1983, the following information was available from Moore Company's accounting records:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/83</td>
<td>$29,400</td>
</tr>
<tr>
<td>Purchases</td>
<td>166,600</td>
</tr>
<tr>
<td>Additional markups</td>
<td>—</td>
</tr>
<tr>
<td>Available for sale</td>
<td>$196,000</td>
</tr>
</tbody>
</table>

Sales for the year totaled $221,200; markdowns amounted to $2,800. Under the approximate lower of average cost or market retail method, Moore's inventory at December 31, 1983, was

a. $39,200
b. $43,120
c. $56,000
d. $61,600

1M84#8. Beal Distribution Company has valued its December 31, 1983, inventory on a FIFO basis at $100,000. Information pertaining to that inventory is as follows:

- Estimated selling price $102,000
- Estimated cost of disposal 5,000
- Normal profit margin 15,000
- Current replacement cost of inventory 90,000

Beal records a loss for any decline in inventory which is to be written down to a lower of cost or market basis. At December 31, 1983, the loss which Beal should recognize is

a. $10,000
b. $7,000
c. $3,000
d. $0

1M84#6. Shunpike Company's inventory records for product Y provide the following data for 1983:

<table>
<thead>
<tr>
<th>Units</th>
<th>Unit cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/83</td>
<td>12,000</td>
</tr>
<tr>
<td>Purchases:</td>
<td></td>
</tr>
<tr>
<td>April 8</td>
<td>20,000</td>
</tr>
<tr>
<td>October 25</td>
<td>8,000</td>
</tr>
</tbody>
</table>

A physical inventory on December 31, 1983, shows 10,000 units on hand. Under the FIFO cost flow method, the December 31, 1983, inventory should be

a. $100,000
b. $99,000
c. $95,000
d. $90,000

1M83#1. Dixon Menswear Shop regularly buys shirts from Colt Company and is allowed trade discounts of 20% and 10% from the list price. Dixon purchased shirts from Colt on May 27, 1983, and received an invoice with a list price amount of $5,000, and payment terms of 2/10, n/30. Dixon uses the net method to record purchases. Dixon should record the purchase at

a. $3,600
b. $3,528
c. $3,500
d. $3,430
1N83#3. Moore Company carries product A in inventory on December 31, 1982, at its unit cost of $7.50. Because of a sharp decline in demand for the product, the selling price was reduced to $8.00 per unit. Moore’s normal profit margin on product A is $1.60, disposal costs are $1.00 per unit, and the replacement cost is $5.30. Under the rule of cost or market, whichever is lower, Moore’s December 31, 1982, inventory of product A should be valued at a unit cost of
a. $5.30  
b. $5.40  
c. $7.00  
d. $7.50

1N83#20. On December 31, 1981, Kern Company adopted the dollar value LIFO inventory method. All of Kern’s inventories constitute a single pool. The inventory on December 31, 1981, using the dollar value LIFO inventory method was $600,000. Inventory data for 1982 are as follows:

12/31/82 inventory at year-end prices $780,000
Relevant price index at year-end
(base year 1981) 120

Under the dollar value LIFO inventory method, Kern’s inventory at December 31, 1982, would be
a. $650,000  
b. $655,000  
c. $660,000  
d. $720,000

2N82#11. The following information pertains to a flange that is carried in the inventory of Mills Wholesalers, Inc.:

<table>
<thead>
<tr>
<th></th>
<th>Per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original cost</td>
<td>$3.00</td>
</tr>
<tr>
<td>Replacement cost</td>
<td>1.20</td>
</tr>
<tr>
<td>Net realizable value</td>
<td>2.40</td>
</tr>
<tr>
<td>Net realizable value, less normal markup</td>
<td>1.68</td>
</tr>
</tbody>
</table>

What should be the carrying value per unit on the basis of lower of cost or market?

a. $1.20  
b. $1.68  
c. $2.40  
d. $3.00

2N82#3. The following items were included in Venicio Corporation’s inventory account at December 31, 1981:

- Merchandise out on consignment, at sales price, including 40% markup on selling price $14,000
- Goods purchased, in transit, shipped f.o.b. shipping point 12,000
- Goods held on consignment by Venicio 9,000

Venicio’s inventory account at December 31, 1981, should be reduced by
a. $14,600  
b. $17,400  
c. $23,000  
d. $35,000

2N81#13. The following pertains to an inventory item held by Moore Wholesalers, Inc., at December 31, 1980:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$60</td>
</tr>
<tr>
<td>Estimated selling price</td>
<td>68</td>
</tr>
<tr>
<td>Estimated cost of disposal</td>
<td>1</td>
</tr>
<tr>
<td>Normal profit margin</td>
<td>11</td>
</tr>
<tr>
<td>Replacement cost</td>
<td>51</td>
</tr>
</tbody>
</table>

Under the lower of cost or market rule, this inventory item should be valued at

a. $51  
b. $56  
c. $60  
d. $67

2N81

Items 15 and 16 are based on the following data: City Stationers, Inc., had 200 calculators on hand at January 1, 1981, costing $18 each. Purchases and sales of calculators during the month of January were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Purchases</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 12</td>
<td>14 @ $20</td>
<td>150 @ $28</td>
</tr>
<tr>
<td>29</td>
<td>100 @ $22</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>100 @ $32</td>
<td></td>
</tr>
</tbody>
</table>

City does not maintain perpetual inventory records. According to a physical count, 150 calculators were on hand at January 31, 1981.

15. The cost of the inventory at January 31, 1981, under the FIFO method is

a. $ 400  
b. $2,700  
c. $3,100  
d. $3,200

16. The cost of the inventory at January 31, 1981, under the LIFO method is

a. $ 400  
b. $2,700  
c. $3,100  
d. $3,200
1M81#2. The following data were available from the records of the Bricker Department Store for the year ended December 31, 1980:

<table>
<thead>
<tr>
<th></th>
<th>At cost</th>
<th>At retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise inventory, January 1, 1980</td>
<td>$180,000</td>
<td>$260,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>660,000</td>
<td>920,000</td>
</tr>
<tr>
<td>Markups</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Markdowns</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>960,000</td>
<td></td>
</tr>
</tbody>
</table>

Using the retail method, an estimate of the merchandise inventory at December 31, 1980, valued at the lower of average cost or market, would be

a. $220,000
b. $160,000
c. $120,000
d. $112,000

2M81#14. Hestor Company's records indicate the following information:

Merchandise inventory, January 1, 1980  $ 550,000
Purchases, January 1 through December 31, 1980  2,250,000
Sales, January 1 through December 31, 1980  3,000,000

On December 31, 1980, a physical inventory determined that ending inventory of $600,000 was in the warehouse. Hestor's gross profit on sales has remained constant at 30%. Hestor suspects some of the inventory may have been taken by some new employees. At December 31, 1980, what is the estimated cost of missing inventory?

a. $100,000
b. $200,000
c. $300,000
d. $700,000

2M81#35. Janis Manufacturing Company recorded the following data pertaining to raw material X:

<table>
<thead>
<tr>
<th>Date</th>
<th>Received</th>
<th>Cost</th>
<th>Issued</th>
<th>On hand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/80 Inventory</td>
<td></td>
<td>1.00</td>
<td></td>
<td>400</td>
</tr>
<tr>
<td>1/8/80 Purchase</td>
<td>600</td>
<td>1.10</td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>1/12/80 Issue</td>
<td>800</td>
<td></td>
<td></td>
<td>200</td>
</tr>
</tbody>
</table>

The weighted average unit cost of raw material X at January 12, 1980, is

a. $1.00
b. $1.05
c. $1.06
d. $1.10

D. Property, Plant, and Equipment Owned or Leased

1M85#11. On January 2, 1985, Rice Company entered into a ten-year noncancellable lease requiring year-end payments of $200,000. Rice's incremental borrowing rate is 12%, while the lessor's implicit interest rate, known to Rice, 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. How much should be capitalized by Rice for this leased property?

a. $0
b. $1,130,000
c. $1,229,000
d. $2,000,000

1N84#9. On February 1, 1984, Tilden Company purchased a tract of land as a factory site for $250,000. An existing building on the property was razed and construction was begun on a new factory building in March 1984. Additional data are available as follows:

Cost of razing old building  $ 30,000
Proceeds from sale of salvaged materials  3,000
Title insurance and legal fees to purchase land  15,000
Architect's fees  60,000
New building construction cost  1,500,000

The capitalized cost of the completed factory building should be

a. $1,560,000
b. $1,575,000
c. $1,587,000
d. $1,590,000

1N84#10. On January 1, 1980, Ott Company purchased a new machine for $360,000. The machine has an estimated useful life of eight years and depreciation is computed by the sum-of-the-years'-digits method. The accumulated depreciation at December 31, 1983, should be

a. $ 50,000
b. $100,000
c. $180,000
d. $260,000

1N84#11. Fifty percent of the machinery owned by Stone Company was destroyed by fire on June 30, 1984. At the date of the fire, the machinery had a book value of $90,000 and a current fair value of $120,000. The machinery was covered by a fire insurance policy with a face amount of $100,000 and a coinsurance clause of 80%. How much should Stone expect to recover from the insurance company?

a. $45,000
b. $48,000
c. $60,000
d. $80,000
1N84#12. On October 31, 1983, West Company received a condemnation award of $450,000 as compensation for the forced sale of a warehouse. On this date the warehouse, including the land on which it was situated, had a book value of $275,000. During December 1983, West purchased a parcel of land for a new warehouse site at a cost of $125,000. West should report on its income statement for the year ended December 31, 1983, a gain on condemnation of property at
a. $0  
b. $50,000  
c. $175,000  
d. $325,000

1N84#13. The following expenditures were among those incurred by Butler Company during 1983:

A broken gear on a machine was replaced $1,500
Replacement of tiles on portion of roof 4,500
Overhaul of machinery that is expected to extend its useful life for another three years 7,500

How much should be charged to repairs and maintenance in 1983?
   a. $1,500  
b. $4,500  
c. $6,000  
d. $9,000

1N84#14. On June 1, 1984, Ichor Company entered into a ten-year noncancellable lease with Gillie, Inc., for a machine owned by Gillie. The machine had a fair value of $180,000 at inception of the lease. Ownership of the machine is transferred to Ichor upon expiration of the lease. The present value of the ten $30,000 annual lease payments, based on Ichor's incremental borrowing rate of 12%, is $190,000. The lease agreement specifies that all executory costs are assumed by Ichor. How much should Ichor record as an asset and corresponding liability at the inception of the lease?
   a. $0  
b. $180,000  
c. $190,000  
d. $300,000

1N84#15. On January 1, 1978, Victor Company purchased for $85,000 a machine having a useful life of ten years and an estimated salvage value of $5,000. The machine was depreciated by the straight-line method. On July 1, 1983, the machine was sold for $45,000. For the year ended December 31, 1983, how much gain should Victor record on the sale?
   a. $0  
b. $1,000  
c. $4,000  
d. $6,750

1N84#16. On January 3, 1983, Sutter Company signed a ten-year noncancellable lease for new equipment, requiring annual payments of $25,000 starting at the beginning of the first year, with title passing to Sutter at the expiration of the lease. The equipment has a useful life of 15 years, with no salvage value. Sutter uses straight-line depreciation for all of its fixed assets. Aggregate lease payments were determined to have a present value of $158,000, based on implicit interest of 12%. For 1983 Sutter should record depreciation expense of
   a. $10,533  
b. $15,800  
c. $15,960  
d. $18,960

1N84#17. On January 1, 1983, Cooke Company made the following expenditures relating to plant machinery and equipment:

Continuing, frequent, and low-cost repairs $36,000
Special long-term protection devices were attached to ten machines 11,000
A broken gear on a machine was replaced 2,000

How much should be charged to repairs and maintenance in 1983?
   a. $36,000  
b. $38,000  
c. $47,000  
d. $49,000

1N84#18. On November 1, 1983, Rice Company purchased for $200,000 a tract of land as a factory site. The old building on the property was razed and salvaged materials resulting from demolition were sold. Additional costs incurred and salvage proceeds realized during November 1983 were as follows:

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

In its November 30, 1983, balance sheet, Rice should report a balance in the land account of
   a. $211,000  
b. $221,000  
c. $230,000  
d. $232,000

1N84#19. Grey Company purchased a machine on January 2, 1982, for $500,000. The machine has an estimated useful life of five years and a salvage value of $50,000. Depreciation was computed by the 150% declining balance method. The accumulated depreciation balance at December 31, 1983, should be
   a. $180,000  
b. $229,500  
c. $245,000  
d. $255,000

1N84#20. The following expenditures relating to the plant building were made by Pine Company during the year ended December 31, 1983:

AP-14
Replacement of the old shingle roof with a fireproof tile roof $75,000
Repainted the plant building 5,000
Major improvements to the electrical wiring system 35,000

How much should be capitalized in 1983?
   a. $35,000
   b. $75,000
   c. $110,000
   d. $115,000

1M84#11. On December 31, 1983, Marsh Company completed the rearrangement of a group of factory machines to secure greater efficiency in production and incurred the following costs:

   Moving costs $20,000
   Reinstallation costs 40,000
   Total $60,000

Marsh estimated that the benefits resulting from the rearrangement would extend over the remaining five-year useful lives of the machines. How much of the rearrangement costs should be capitalized at December 31, 1983?
   a. $0
   b. $20,000
   c. $40,000
   d. $60,000

1M84#13. On January 2, 1983, Evans Company signed an eight-year lease for office space. Evans has the option to renew the lease for an additional four-year period on or before January 2, 1990. During January 1983 Evans incurred the following costs:

   • $120,000 for general improvements to the leased premises with an estimated useful life of ten years.
   • $160,000 for office furniture and equipment with an estimated useful life of ten years.

At December 31, 1983, Evans’ intentions as to exercise of the renewal option are uncertain since they depend upon future office space requirements. Assuming that a full year’s amortization of leasehold improvements is taken for calendar year 1983, Evans should record amortization expense of
   a. $10,000
   b. $12,000
   c. $15,000
   d. $28,000

1M84#14. Hines Company leased a new machine from Ashwood Company on December 31, 1982, under a lease with the following pertinent information:

   Lease term 8 years
   Annual rental payable at the beginning of each lease year $50,000
   Useful life of the machine 10 years
   Present value of the 8 lease payments at 12/31/82 $258,000
   Machine reverts to Ashwood at lease expiration date

The machine has a fair value of $280,000 at the inception of the lease. Hines uses the straight-line method of depreciation. For the year ended December 31, 1983, how much depreciation (amortization) should Hines record for the capitalized leased machine?
   a. $35,000
   b. $32,250
   c. $28,000
   d. $25,800

1N83#23. On August 29, 1983, Hadley Company sustained a loss from a fire that completely destroyed a machine with a fair value of $30,000. The machine was covered by an insurance policy with a face amount of $18,000 and a coinsurance clause of 80%. How much should Hadley expect to recover from the insurance company?
   a. $24,000
   b. $22,500
   c. $18,000
   d. $14,400

1N83#25. On June 30, 1982, a fire in Ruffing Company’s plant caused a total loss to a production machine. The machine had a book value of $80,000 at December 31, 1981, and was being depreciated at an annual rate of $10,000. The machine had a fair value of $110,000 at the date of the fire, and Ruffing received insurance proceeds of $100,000 in October 1982. The same month Ruffing purchased a replacement machine for $130,000. Ignoring income taxes, what amount should Ruffing report on its 1982 income statement as involuntary conversion gain or loss?
   a. $0
   b. $10,000 loss.
   c. $20,000 gain.
   d. $25,000 gain.

1N83#27. On January 1, 1978, Walton Company purchased a machine for $200,000 and established an annual straight-line depreciation rate of 10%, with no salvage value. During 1982 Walton determined that the machine will not be economically useful in its production process after December 31, 1982. Walton estimated that the machine had no scrap value at December 31, 1982, and would be disposed of in early 1983 at a
cost of $5,000. In its income statement for the year ended December 31, 1982, what amount(s) and type of charge(s) should Walton report for the machine?

<table>
<thead>
<tr>
<th>Depreciation Expense</th>
<th>Loss on Abandonment</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$125,000</td>
</tr>
<tr>
<td>b. $20,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>c. $20,000</td>
<td>$105,000</td>
</tr>
<tr>
<td>d. $120,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

1M83#28. Barker Company leased a new machine from Bell Company on July 1, 1983, under a lease with the following pertinent information:

- Lease term: 10 years
- Annual rental payable at the beginning of each lease year: $30,000
- Useful life of the machine: 12 years
- Implicit interest rate: 14%
- Present value of an annuity of $1 in advance for 10 periods at 14%: 5.95
- Present value of $1 for 10 periods at 14%: 0.27

Barker has the option to purchase the machine on July 1, 1993, by paying $40,000, which approximates the expected fair value of the machine on the option exercise date. The cost of the machine on Bell's accounting records is $150,000. On July 1, 1983, Barker should record a capitalized leased asset of

a. $150,000
b. $178,500
c. $189,300
d. $190,000

1M83#35. Crowder Company acquired a tract of land containing an extractable natural resource. Crowder is required by the purchase contract to restore the land to a condition suitable for recreational use after it has extracted the natural resource. Geological surveys estimate that the recoverable reserves will be 5,000,000 tons, and that the land will have a value of $1,000,000 after restoration. Relevant cost information follows:

- Land: $9,000,000
- Estimated restoration costs: 1,500,000

If Crowder maintains no inventories of extracted material, what should be the charge to depletion expense per ton of extracted material?

a. $2.10
b. $1.90
c. $1.80
d. $1.60

1M83#5. On January 4, 1982, Hadley Company signed a 10-year nonrenewable lease for a building to be used in its manufacturing operations. During January 1982 Hadley incurred the following costs:

- $64,000 for general improvements to the leased premises with an estimated useful life of eight years.
- $32,000 for a movable assembly line equipment installation with an estimated useful life of eight years.

A full year's amortization is taken for the calendar year 1982. What amount should Hadley record as amortization of leasehold improvements for 1982?

- a. $6,400
- b. $8,000
- c. $9,600
- d. $12,000

2M83#1. On September 1, 1982, Sol, Inc., exchanged 2,000 shares of its $25 par value common stock held in treasury, for a parcel of land to be held for a future plant site. The treasury shares were acquired by Sol at a cost of $60 per share. Sol's common stock had a fair market value of $80 per share on September 1, 1982. Sol received $9,000 from the sale of scrap when an existing building on the site was razed. The land should be carried at

- a. $111,000
- b. $120,000
- c. $151,000
- d. $160,000

2M83#14. Herr, Inc., has a fiscal year ending April 30. On May 1, 1982, Herr borrowed $10,000,000 at 15% to finance construction of its own building. Repayments of the loan are to commence the month following completion of the building. During the year ended April 30, 1983, expenditures for the partially completed structure totaled $6,000,000. These expenditures were incurred evenly throughout the year. Interest earned on the unexpended portion of the loan amounted to $400,000 for the year. How much should be shown as capitalized interest on Herr's financial statements at April 30, 1983?

- a. $0
- b. $50,000
- c. $450,000
- d. $1,100,000

2M83

Items 21 and 22 are based on the following information:

On January 2, 1982, Doe Company leased a new crane from Leasement Corp. under the following terms:

- Noncancellable for eight years
- Annual lease payments of $10,000 beginning January 2, 1982, through January 2, 1989
- Nonrenewable
- Crane to be returned to Leasement on January 2, 1990
Doe properly recorded the crane as a “Leased asset — crane” in the amount of $52,880, based on a 14% interest rate implicit in the lease. Leasement paid $56,000 for the crane on December 31, 1981. The crane has an estimated useful life of ten years, with no salvage value. Both Doe and Leasement use the straight-line method of depreciation.

   a. $0
   b. $ 6,610
   c. $ 7,000
   d. $10,000

2M83#23. On June 18, 1982, Paul Printing Company incurred the following costs for one of its printing presses:

| Purchase of collating and stapling attachment | $42,000 |
| Installation of attachment | 18,000 |
| Replacement parts for overhaul of press | 13,000 |
| Labor and overhead in connection with overhaul | 7,000 |
| **Total** | **$80,000** |

The overhaul resulted in a significant increase in production. Neither the attachment nor the overhaul increased the estimated useful life of the press. How much of the above costs should be capitalized?
   a. $42,000
   b. $35,000
   c. $60,000
   d. $80,000

2M83

Items 31 through 33 are based on the following information:

Vorst Corporation’s schedule of depreciable assets at December 31, 1981, was as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>Accumulated depreciation</th>
<th>Acquisition date</th>
<th>Salvage value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$100,000</td>
<td>$ 64,000</td>
<td>1980</td>
<td>$20,000</td>
</tr>
<tr>
<td>B</td>
<td>55,000</td>
<td>36,000</td>
<td>1979</td>
<td>10,000</td>
</tr>
<tr>
<td>C</td>
<td>70,000</td>
<td>33,600</td>
<td>1979</td>
<td>14,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$225,000</strong></td>
<td><strong>$133,600</strong></td>
<td></td>
<td><strong>$44,000</strong></td>
</tr>
</tbody>
</table>

Vorst takes a full year's depreciation expense in the year of an asset’s acquisition, and no depreciation expense in the year of an asset’s disposition. The estimated useful life of each depreciable asset is five years.

   a. $32,000
   b. $25,600
   c. $14,400
   d. $ 6,400

32. Using the same depreciation method as used in 1979, 1980, and 1981, how much depreciation expense should Vorst record in 1982 for asset B?
   a. $ 6,000
   b. $(2,800)
   c. $(5,600)
   d. $(8,400)

33. Vorst depreciates asset C by the straight-line method. On June 30, 1982, Vorst sold asset C for $28,000 cash. How much gain or (loss) should Vorst record in 1982 on the disposal of asset C?
   a. $2,800
   b. $(2,800)
   c. $(5,600)
   d. $(8,400)

1N82#13. White Airlines sold a used jet aircraft to Brown Company for $800,000, accepting a five-year 6% note for the entire amount. Brown's incremental borrowing rate was 14%. The annual payment of principal and interest on the note was to be $189,930. The aircraft could have been sold at an established cash price of $651,460. The present value of an ordinary annuity of $1 at 8% for five periods is 3.99. The aircraft should be capitalized on Brown’s books at
   a. $651,460
   b. $757,820
   c. $800,000
   d. $949,650

2N82#2. The following expenditures were among those incurred by Jensen Corporation during the year ended December 31, 1981:

- Replacement of tiles on portion of roof that had been leaking $4,000
- Overhaul of machinery that is expected to extend its useful life for another two years 6,000

How much should be charged to repairs and maintenance in 1981?
   a. $0
   b. $ 4,000
   c. $ 6,000
   d. $10,000
1M82#2. Wright Company bought a building on July 1, 1979, for $130,000. A fire insurance policy with a face amount of $100,000 and a coinsurance clause of 80% was taken out on the building. On February 2, 1982, the building was partially destroyed by fire and the loss was estimated at $120,000. Assuming that the fair market value of the building was $180,000 at the date of the fire, how much should Wright expect to recover from the insurance company?

a. $80,000
b. $83,333
c. $96,000
d. $100,000

1M82#9. In January 1980 Colonial Company purchased equipment for $120,000, to be used in its manufacturing operations. The equipment was estimated to have a useful life of 8 years, with salvage value estimated at $12,000. Colonial considered various methods of depreciation and selected the sum-of-the-years'-digits method. On December 31, 1981, the related allowance for accumulated depreciation should have a balance

a. $15,000 less than under the straight-line method.
b. $15,000 less than under the double-declining-balance method.
c. $18,000 greater than under the straight-line method.
d. $18,000 greater than under the double-declining-balance method.

1M82#12. On July 1, 1981, Stone Corporation received a condemnation award of $300,000 as compensation for the forced sale of a plant located on company property which stood in the path of a new highway. On this date the plant building had a depreciated cost of $150,000 and the land cost was $50,000. On October 1, 1981, Stone purchased a parcel of land for a new plant site at a cost of $125,000. Ignoring income taxes, Stone should report on its income statement for the year ended December 31, 1981, a gain of

a. $0
b. $25,000
c. $75,000
d. $100,000

2N81#9. On January 2, 1980, Lafayette Machine Shops, Inc., signed a ten-year noncancellable lease for a heavy duty drill press, stipulating annual payments of $15,000 starting at the end of the first year, with title passing to Lafayette at the expiration of the lease. Lafayette treated this transaction as a capital lease. The drill press has an estimated useful life of 15 years, with no salvage value. Lafayette uses straight-line depreciation for all of its fixed assets. Aggregate lease payments were determined to have a present value of $92,170, based on implicit interest of 10%. For 1980, Lafayette should record

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>Depreciation expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $7,717</td>
<td>$6,145</td>
</tr>
<tr>
<td>c. $9,217</td>
<td>$6,145</td>
</tr>
<tr>
<td>d. $9,217</td>
<td>$9,217</td>
</tr>
</tbody>
</table>

2N81#14. During 1980, Belardo Corporation constructed and manufactured certain assets, and incurred the following interest costs in connection with those activities:

<table>
<thead>
<tr>
<th>Interest costs incurred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warehouse constructed for Belardo's own use</td>
</tr>
<tr>
<td>Special-order machine for sale to unrelated customer, produced according to customer's specifications</td>
</tr>
<tr>
<td>Inventories routinely manufactured, produced on a repetitive basis</td>
</tr>
</tbody>
</table>

All of these assets required an extended period of time for completion. Assuming the effect of interest capitalization is material, what is the total amount of interest costs to be capitalized?

a. $0
b. $20,000
c. $29,000
d. $36,000

2N81#23. On July 1, 1980, Mundo Corporation purchased factory equipment for $50,000. Salvage value was estimated at $2,000. The equipment will be depre-
cated over ten years using the double-declining-balance method. Counting the year of acquisition as one-half year, Mundo should record 1981 depreciation expense of
a. $ 7,680  
b. $ 9,000  
c. $ 9,600  
d. $10,000

2N81#28. On July 1, 1981, Molloy Corporation entered into a 10-year noncancellable lease with Macless, Inc., for a machine owned by Macless. The machine had a fair value of $200,000 at inception of the lease, and an estimated useful life of 13 years. Present value of the minimum lease payments is $120,000, and executory costs amounted to $3,000. Molloy is obligated to return the machine to Macless upon expiration of the lease. No bargain purchase option is provided. How much should Molloy record as an asset and corresponding liability at the inception of this lease?
   a. $0  
b. $120,000  
c. $123,000  
d. $200,000

2N81#31. On January 1, 1980, Yuki Yogurt Company decided to replace its obsolete refrigeration system with a more efficient one. The old system had a book value of $9,000 and a fair market value of $1,000. Yuki's new refrigeration system has a fair market value of $190,000, for which Yuki paid $189,000 after permitting the contractor to keep the old refrigeration equipment. How much should Yuki capitalize as the cost of the new refrigeration system?
   a. $189,000  
b. $190,000  
c. $197,000  
d. $198,000

2N81#34. Caravan Corporation owned a warehouse located in the path of a proposed highway. Caravan bought the land in 1940 for $10,000. That same year, it built the warehouse at a cost of $50,000. In 1980, after prolonged litigation, the state exercised its right of eminent domain and condemned the property, awarding Caravan $200,000. Depreciation accumulated to the date of the award was $45,000. On its 1980 federal income tax return, Caravan elected not to recognize the gain since replacement property was bought for $225,000. For income statement purposes, Caravan should recognize a gain in 1980 of
   a. $0  
b. $160,000  
c. $185,000  
d. $200,000

1M81#9. On January 1, 1979, Current Company purchased a new machine for $5,000,000. The new machine has an estimated useful life of five years and the salvage value was estimated to be $500,000. Current uses the sum-of-the-years'-digits method of depreciation. The amount of depreciation expense for 1980 (the second year) would be
   a. $ 800,000  
b. $1,200,000  
c. $1,333,333  
d. $1,500,000

1M81#11. On January 1, 1980, Richmond, Inc., signed a fixed-price contract to have Builder Associates construct a major plant facility at a cost of $4,000,000. It was estimated that it would take three years to complete the project. Also on January 1, 1980, to finance the construction cost, Richmond borrowed $4,000,000 payable in 10 annual installments of $400,000, plus interest at the rate of 11%. During 1980 Richmond made deposit and progress payments totaling $1,500,000 under the contract; the average amount of accumulated expenditures was $650,000 for the year. The excess borrowed funds were invested in short-term securities, from which Richmond realized investment income of $250,000. What amount should Richmond report as capitalized interest at December 31, 1980?
   a. $ 71,500  
b. $165,000  
c. $190,000  
d. $440,000

1M81#34. Electro Corporation bought a new machine and agreed to pay for it in equal annual installments of $5,000 at the end of each of the next five years. Assume a prevailing interest rate of 15%. The present value of an ordinary annuity of $1 at 15% for five periods is 3.35. The future amount of an ordinary annuity of $1 at 15% for five periods is 6.74. The present value of $1 at 15% for five periods is 0.5. How much should Electro record as the cost of the machine?
   a. $12,500  
b. $16,750  
c. $25,000  
d. $33,700

E. Intangibles and Other Assets

1M85#12. Taft, Inc., incurred $150,000 of research and development costs in its laboratory to develop a patent granted on January 2, 1980. Legal fees and other costs associated with registration of the patent totaled $25,000. On March 31, 1985, Taft paid $35,000 for legal fees in a successful defense of the patent. The total amount capitalized for this patent through March 31, 1985, should be
   a. $ 25,000  
b. $ 60,000  
c. $175,000  
d. $210,000

1M85#19. On February 15, 1985, Reed Corporation paid $1,500,000 for all the issued and outstanding common stock of Cord, Inc., in a transaction properly ac-
counted for as a purchase. The book values and fair values of Cord’s assets and liabilities on February 15, 1985, were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book value</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$160,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>180,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>290,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Property, plant &amp; equipment</td>
<td>(350,000)</td>
<td>(350,000)</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net worth</td>
<td>$1,150,000</td>
<td>$1,220,000</td>
</tr>
</tbody>
</table>

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

a. $0
b. $70,000
c. $280,000
d. $350,000

1N85#20. On December 1, 1984, Rhan Corporation leased office space for five years at a monthly rental of $10,000. On that date Rhan paid the lessor the following amounts:

- Rent security deposit: $25,000
- First month’s rent: 10,000
- Last month’s rent: 10,000
- Nonrefundable payment (reimburses lessor for modifications to the leased premises): 60,000

The entire amount of $105,000 was charged to rent expense in 1984. What portion of the payments should Rhan have deferred to years subsequent to 1984?

a. $35,000
b. $85,000
c. $94,000
d. $95,000

1N84#14. On July 1, 1983, Walton Company leased office premises for a three-year period at an annual rental of $36,000 payable on July 1 each year. The first rent payment was made July 1, 1983. Additionally on July 1, 1983, Walton paid $24,000 as a lease bonus to obtain a three-year lease instead of the lessor’s usual lease term of six years. In its December 31, 1983, balance sheet, Walton should report prepaid rent of

a. $18,000
b. $22,000
c. $24,000
d. $38,000

1N84#17. On July 1, 1984, James Rago signed an agreement to operate as a franchisee of Fast Foods, Inc., for an initial franchise fee of $60,000. Of this amount, $20,000 was paid when the agreement was signed, and the balance is payable in four equal annual payments of $10,000 beginning July 1, 1985. The agreement provides that the down payment is not refundable and no future services are required of the franchisor. Rago’s credit rating indicates that he can borrow money at 14% for a loan of this type. Information on present and future value factors is as follows:

<table>
<thead>
<tr>
<th>Factor</th>
<th>Present value of $1 at 14% for 4 periods</th>
<th>Future amount of $1 at 14% for 4 periods</th>
<th>Present value of an ordinary annuity of $1 at 14% for 4 periods</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0.59</td>
<td>1.69</td>
<td>2.91</td>
</tr>
</tbody>
</table>

Rago should record the acquisition cost of the franchise on July 1, 1984, at

a. $43,600
b. $49,100
c. $60,000
d. $67,600

1N84#36. For the year ended December 31, 1983, Dunn Corporation reported rent income of $225,000 in its income statement. Rents received, reported as taxable income in the year received, amounted to $350,000 for 1983. Also in 1983, Dunn had a nondeductible unrealized loss of $60,000, from a foreign currency transaction, which will be deductible when realized. Dunn’s effective income tax rate is 40%. By what amount would the asset, deferred income tax, account balance increase for 1983?

a. $111,000
b. $74,000
c. $50,000
d. $26,000

1N84#58. Greene Company bought a franchise from White Company on January 1, 1983, for $102,000. An independent research consultant retained by Greene estimated that the remaining useful life of the franchise was 50 years. Its unamortized cost on White’s books at January 1, 1983, was $34,000. Greene has decided to write off the franchise over the maximum period allowed. How much should be amortized for the year ended December 31, 1983?

a. $850
b. $2,000
c. $2,040
d. $2,550

1N84#12. On October 31, 1983, Simpson, Inc., purchased for cash of $40 per share all 250,000 of the outstanding common stock of Rex Corporation. Rex’s balance sheet at October 31, 1983, showed a book value of $8,000,000. Additionally, the fair value of Rex’s property, plant and equipment on that date was $900,000 in excess of its book value. In the October
31, 1983, consolidated balance sheet of Simpson, Inc., and its wholly owned subsidiary, what amount should be reported as goodwill?

a. $0
b. $ 900,000
c. $1,100,000
d. $2,000,000

1M84#15. Ward Company purchased a patent on January 1, 1980, for $357,000. The patent was being amortized over its remaining legal life of 15 years expiring on January 1, 1995. During 1983 Ward determined that the economic benefits of the patent would not last longer than ten years from the date of acquisition. What amount should be charged to patent amortization expense for the year ended December 31, 1983?

a. $21,000
b. $35,700
c. $40,800
d. $71,400

1M84#17. In 1983 Stone Corporation received interest income of $50,000 on U.S. Government obligations and $300,000 in royalties under a licensing agreement. Royalties are reported as taxable income in the year received, but in the financial statements, royalties are recognized as income in the year earned and amounted to $200,000 for the year ended December 31, 1983. Stone’s effective income tax rate is 40%. By what amount would the deferred income tax asset account balance increase for 1983?

a. $20,000
b. $40,000
c. $60,000
d. $80,000

1M84#18. Brown Company adopted a noncontributory pension plan on January 1, 1983. Brown decided to amortize the past service cost over 15 years and to fund this cost by making equal payments to the fund trustee at the end of each of the first ten years. The normal pension cost is also funded fully at the end of each year. The following pension plan data are available for 1983:

| Normal pension cost | $80,000 |
| Past service cost:  |        |
| Amortized           | 46,700 |
| Funded              | 59,600 |

In its December 31, 1983, balance sheet, Brown should report deferred pension cost at

a. $12,900
b. $20,400
c. $46,700
d. $59,600

1M83#40. Metropol Football Company had a player contract with Allen that is recorded in its books at $250,000 on July 1, 1983. Wildcat Football Company had a player contract with Baxter that is recorded in its books at $300,000 on July 1, 1983. On this date Metropol traded Allen to Wildcat for Baxter and paid a cash difference of $25,000. The fair value of the Baxter contract was $550,000 on the exchange date. After the exchange, the Baxter contract should be recorded in Metropol’s books at

a. $275,000
b. $300,000
c. $325,000
d. $350,000

1M83#4. On April 1, 1983, Union Company paid $1,600,000 for all the issued and outstanding common stock of Cable Corporation in a transaction properly accounted for as a purchase. The recorded assets and liabilities of Cable on April 1, 1983, were as follows:

| Cash              | $160,000 |
| Inventory        | 480,000  |
| Property, plant and equipment (net) | 960,000 |
| Liabilities      | (360,000)

On April 1, 1983, it was determined that Cable’s inventory had a fair value of $460,000, and the property, plant and equipment (net) had a fair value of $1,040,000. What is the amount of goodwill resulting from the business combination?

a. $0
b. $ 20,000
c. $300,000
d. $360,000

1M83#6. Under Gerber Company’s accounting system, all insurance premiums paid are debited to prepaid insurance. For interim financial statements, Gerber makes monthly estimated charges to insurance expense with an offset to prepaid insurance. Additional information for the year ended December 31, 1982, is as follows:

Prepaid insurance at December 31, 1981 $150,000
Charges to insurance expense during 1982 (including a year-end adjustment of $25,000) 625,000
Unexpired insurance premiums at December 31, 1982 175,000

What was the total amount of insurance premiums paid by Gerber during 1982?

a. $475,000
b. $600,000
c. $625,000
d. $650,000

2M82#13. Howe Corporation bought a cola franchise from Pennington, Inc., on January 2, 1981, for $100,000. A highly regarded independent research company estimated that the remaining useful life of the franchise was 50 years. Its unamortized cost on Pennington’s books at January 1, 1981, was $15,000. Howe
has decided to write off the franchise over the longest possible period. How much should be amortized for the year ended December 31, 1981?
   a. $ 375  
   b. $ 2,000  
   c. $ 2,500  
   d. $15,000

1N81#12. Sherwood Corporation incurred $68,000 of research and development costs in its laboratory to develop a patent which was granted on January 2, 1980. Legal fees and other costs associated with registration of the patent totaled $13,600. Sherwood estimates that the economic life of the patent will be eight years. What amount should Sherwood charge to patent amortization expense for the year ended December 31, 1980?
   a. $0  
   b. $ 800  
   c. $ 1,700  
   d. $10,200

2N81#5. During 1975, Traco Machine Company spent $176,000 on research and development costs for an invention. This invention was patented on January 2, 1976, at a nominal cost that was expensed in 1976. The patent had a legal life of 17 years and an estimated useful life of 8 years. In January 1980, Traco paid $16,000 for legal fees in a successful defense of the patent. Amortization for 1980 should be
   a. $0  
   b. $ 1,231

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

A. Payables and Accruals

2M85#1. During the year ended December 31, 1984, Pine Co. paid $46,000 for interest, but Pine's 1984 income statement properly reported interest expense of $50,000. There was no prepaid interest either at the beginning or at the end of 1984. Accrued interest at December 31, 1984, amounted to $5,000. How much was the accrued interest at December 31, 1983?
   a. $0  
   b. $1,000  
   c. $4,000  
   d. $5,000

2M85#2. On January 1, 1984, Oak Co. leased a building to Daly Co. for a ten-year term, at an annual rental of $100,000. At inception of the lease Oak received $200,000, covering the first year's rent of $100,000 and a security deposit of $100,000. This deposit will not be returned to Daly upon expiration of the lease, but will instead be applied to payment of rent for the last year of the lease. Oak properly reported rental income of $200,000 in its 1984 income tax return. At December 31, 1984, what portion of the $200,000 should be shown as a liability in Oak's balance sheet?
   a. $0  
   b. $80,000  
   c. $90,000  
   d. $100,000

2M85#7. At December 31, 1984, Reed Corp. owed notes payable of $1,000,000 with a maturity date of April 30, 1985. These notes did not arise from transactions in the normal course of business. On February 1, 1985, Reed issued $3,000,000 of ten-year bonds with the intention of using part of the bond proceeds to liquidate the $1,000,000 of notes payable maturing in April. On March 1, 1985, Reed did in fact liquidate the $1,000,000 of notes payable, using proceeds from the bond issue. Reed's December 31, 1984, financial statements were issued on March 29, 1985. How much
of the $1,000,000 notes payable should be classified as long-term in Reed’s balance sheet at December 31, 1984?

a. $0  
   b. $ 100,000  
   c. $ 900,000  
   d. $1,000,000

1N84#21. For the year ended December 31, 1983, Rex Corporation reported book income, before federal income taxes, of $1,000,000. Selected information for 1983 is available from Rex’s records as follows:

Interest income on municipal bonds $ 80,000  
Depreciation claimed on tax return in excess of depreciation per books 140,000  
Warranty expense on the accrual basis 65,000  
Actual warranty expenditures 35,000

Rex’s effective income tax rate is 40% for 1983. Rex’s current liability for 1983 federal income taxes (before reduction for estimated taxes paid) should be

a. $312,000  
   b. $324,000  
   c. $368,000  
   d. $400,000

1M84#16. On January 1, 1983, Trapp Company adopted a noncontributory pension plan which requires Trapp to make annual payments to an independent trustee two months after the end of each year. The first payment was due on February 29, 1984. Information relating to the pension plan is as follows:

Past service cost at 1/1/83 (unfunded) $500,000  
Normal cost for 1983 150,000  
Funds held by the trustee are expected to earn a 6% return

Trapp elects to minimize its annual pension cost. At December 31, 1983, how much should Trapp accrue for pension expense?

a. $150,000  
   b. $159,000  
   c. $180,000  
   d. $200,000

1M84#19. Farr Company 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 for this purpose. 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 1984 for the three salespersons in sales region 101 are as follows:

<table>
<thead>
<tr>
<th>Salesperson</th>
<th>Fixed salary</th>
<th>Net sales</th>
<th>Commission rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$2,500</td>
<td>$100,000</td>
<td>2%</td>
</tr>
<tr>
<td>B</td>
<td>3,500</td>
<td>200,000</td>
<td>3%</td>
</tr>
<tr>
<td>C</td>
<td>4,500</td>
<td>300,000</td>
<td>3%</td>
</tr>
</tbody>
</table>

$10,500 $600,000

In respect of sales region 101, what total amount should Farr accrue for sales commissions payable at March 31, 1984?

a. $6,500  
   b. $7,000  
   c. $17,000  
   d. $17,500

1M84#20. During 1982 Waldron Company introduced a new line of machines that carry a two-year warranty against manufacturer’s defects. Based on industry experience, the estimated warranty costs related to dollar sales are as follows:

<table>
<thead>
<tr>
<th>Year of sale</th>
<th>4%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year after sale</td>
<td>6%</td>
</tr>
</tbody>
</table>

Sales and actual warranty expenditures for the years ended December 31, 1982 and 1983 were as follows:

<table>
<thead>
<tr>
<th>Sales</th>
<th>Actual warranty expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>$ 500,000  $15,000</td>
</tr>
<tr>
<td>1983</td>
<td>700,000  47,000</td>
</tr>
<tr>
<td></td>
<td>$1,200,000  $62,000</td>
</tr>
</tbody>
</table>

What amount should Waldron report as its estimated warranty liability at December 31, 1983?

a. $0  
   b. $16,000  
   c. $42,000  
   d. $58,000

1N83#24. On January 7, 1983, Dean Company discounted its own $100,000, 180-day note at United National Bank at a discount rate of 20%. Dean repaid the note on the July 6, 1983, due date. Based on a 360-day year, the effective rate of interest on the borrowing was

a. 18.2%  
   b. 20.0%  
   c. 22.2%  
   d. 25.0%
1N83#30. Bronson Apparel, Inc., operates a retail store and must determine the proper December 31, 1982, year-end accrual for the following expenses:

- The store lease calls for fixed rent of $1,000 per month, payable at the beginning of the month, and additional rent equal to 6% of net sales over $200,000 per calendar year, payable on January 31 of the following year. Net sales for 1982 are $800,000.
- Bronson has personal property subject to a city property tax. The city's fiscal year runs from July 1 to June 30 and the tax, assessed at 3% of personal property on hand at April 30, is payable on June 30. Bronson estimates that its personal property tax will amount to $6,000 for the city's fiscal year ending June 30, 1983.

In its December 31, 1982, balance sheet, Bronson should report accrued expenses of
  a. $39,000
  b. $39,600
  c. $51,000
  d. $51,600

1N83#34. During 1982 Peterson Company experienced financial difficulties and is likely to default on a $500,000, 15%, three-year note dated January 1, 1981, payable to Forest National Bank. On December 31, 1982, the bank agreed to settle the note and unpaid interest of $75,000 for 1982 for $50,000 cash and marketable securities having a current market value of $375,000. Peterson's acquisition cost of the securities is $385,000. Ignoring income taxes, what amount should Peterson report as a gain from the debt restructuing in its 1982 income statement?
  a. $ 65,000
  b. $ 75,000
  c. $140,000
  d. $150,000

1M83#1. The balance in Ashwood Company's accounts payable account at December 31, 1982, was $900,000 before any necessary year-end adjustment relating to the following:

- Goods were in transit from a vendor to Ashwood on December 31, 1982. The invoice cost was $50,000, and the goods were shipped F.O.B. shipping point on December 29, 1982. The goods were received on January 4, 1983.
- Goods shipped F.O.B. shipping point on December 20, 1982, from a vendor to Ashwood were lost in transit. The invoice cost was $25,000. On January 5, 1983, Ashwood filed a $25,000 claim against the common carrier.
- Goods shipped F.O.B. destination on December 21, 1982, from a vendor to Ashwood were received on January 6, 1983. The invoice cost was $15,000.

What amount should Ashwood report as accounts payable on its December 31, 1982, balance sheet?
  a. $925,000
  b. $940,000
  c. $950,000
  d. $975,000

1M83#7. Morgan Company determined that: (1) it has a material obligation relating to employees' rights to receive compensation for future absences attributable to employees' services already rendered, (2) the obligation relates to rights that vest, and (3) payment of the compensation is probable. The amount of Morgan's obligation as of December 31, 1982, is reasonably estimated for the following employee benefits:

| Vacation pay | $100,000 |
| Holiday pay | 25,000 |

What total amount should Morgan report as its liability for compensated absences in its December 31, 1982, balance sheet?
  a. $0
  b. $ 25,000
  c. $100,000
  d. $125,000

1M83#9. The books of Curtis Company for the year ended December 31, 1982, showed income of $360,000 before provision for income tax. In computing the taxable income for federal income tax purposes, the following differences were taken into account:

| Depreciation deducted for tax purposes in excess of depreciation recorded on the books | $16,000 |
| Income from installment sale reportable for tax purposes in excess of income recognized on the books | $12,000 |
Selected Questions

Assuming a corporate income tax rate of 40%, what should Curtis record as its current federal income tax liability at December 31, 1982?

a. $137,600
b. $142,400
c. $144,000
d. $145,600

1M83#13. Dell Company sells its products in reusable, expensive 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. Dell accounts for the containers not returned within the time limit as being retired by sale at the deposit amount. Information for 1982 is as follows:

Containers held by customers at December 31, 1981, from deliveries in:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>1981</td>
<td>$145,000</td>
</tr>
</tbody>
</table>

Containers delivered in 1982:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>260,000</td>
</tr>
</tbody>
</table>

Containers returned in 1982 from deliveries in:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>30,000</td>
</tr>
<tr>
<td>1981</td>
<td>85,000</td>
</tr>
<tr>
<td>1982</td>
<td>95,000</td>
</tr>
</tbody>
</table>

What amount should Dell report as a liability for returnable containers at December 31, 1982?

a. $165,000
b. $215,000
c. $225,000
d. $245,000

2N82#12. Lee Corporation has a noncontributory pension plan covering substantially all of its employees. Lee's policy is to fund pension costs as accrued. At December 31, 1981, the actuarially computed value of vested benefits equalled the cash on deposit with the trustee. The total pension expense for 1981 was $900,000, which included normal cost of $700,000 and amortization of past service cost of $200,000. The unamortized balance of past service cost at December 31, 1981, was $600,000. How much should appear on Lee's balance sheet at December 31, 1981, for pension liability?

a. $0
b. $200,000
c. $600,000
d. $900,000

2M82#20. Reynella Corporation commenced operations on January 1, 1981. For the year ended December 31, 1981, Reynella had pretax income of $1,500,000, after accruing estimated warranty expense of $570,000. Reynella's effective income tax rate was 40%, resulting in income tax payable of $624,000 and deferred income tax of $24,000 at December 31, 1981. What was the amount of actual warranty payments in 1981?

a. $0
b. $510,000
c. $570,000
d. $630,000

1M81#3. During 1978 Lawton Company introduced a new line of machines that carry a three-year warranty against manufacturer's defects. Based on industry experience, warranty costs are estimated at 2% of sales in the year of sale, 4% in the year after sale, and 6% in the second year after sale. Sales and actual warranty expenditures for the first three-year period were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Actual warranty expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>$200,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>1979</td>
<td>500,000</td>
<td>15,000</td>
</tr>
<tr>
<td>1980</td>
<td>700,000</td>
<td>45,000</td>
</tr>
<tr>
<td></td>
<td>$1,400,000</td>
<td>$63,000</td>
</tr>
</tbody>
</table>

What amount should Lawton report as a liability at December 31, 1980?

a. $0
b. $5,000
c. $68,000
d. $105,000

1M81#7. On January 1, 1980, Pierce, Inc., adopted a noncontributory pension plan for all of its eligible employees. The plan requires Pierce to make annual payments to the designated trustee three months after the end of each year. The first payment was due on March 31, 1981. Information relating to the plan is as follows:

Normal cost for 1980: $200,000
Past service cost at January 1, 1980 (unfunded): 1,000,000
Funds held by the trustee are expected to earn an 8% return.

Assuming that Pierce elects to maximize its pension expense in accordance with GAAP, what would be the amount of accrued pension expense at December 31, 1980?

a. $216,000
b. $280,000
c. $300,000
d. $380,000

1M81#15. Stark, Inc., has $1,000,000 of notes payable due June 15, 1981. At the financial statement date of December 31, 1980, Stark signed an agreement to borrow up to $1,000,000 to refinance the notes payable on a long-term basis. The financing agreement called for borrowings not to exceed 80% of the value of the col-
lateral Stark was providing. At the date of issue of the December 31, 1980, financial statements the value of the collateral was $1,200,000 and was not expected to fall below this amount during 1981. On the December
31, 1980, balance sheet, Stark should classify
a. $40,000 of notes payable as short-term and
$960,000 as long-term obligations.
b. $200,000 of notes payable as short-term and
$800,000 as long-term obligations.
c. $1,000,000 of notes payable as short-term ob-
ligations.
d. $1,000,000 of notes payable as long-term obligations.

2M81#9. Bold Company estimates its annual warranty expense at 2% of annual net sales. The following data
are available:

Net sales for 1980 $ 4,000,000
Warranty liability account:
December 31, 1979 $60,000 credit
Warranty payments during 1980 50,000 debit

After recording the 1980 estimated warranty expense, the warranty liability account would show a December
31, 1980, balance of
a. $10,000
b. $70,000
c. $80,000
d. $90,000

2M81
Items 31 and 32 pertain to classification of short-term obligations expected to be refinanced, and are based
on the following data:

Royal Corporation's liabilities at December 31, 1980, were as follows:

Trade accounts payable $100,000
16% notes payable issued November 1, 1980, maturing July 1, 1981 30,000
14% debentures payable issued February 1, 1980; final install-
ment due February 1, 1985; balance at December 31, 1980,
including annual installment of $50,000 due February 1, 1981 300,000
$430,000

Royal's December 31, 1980, financial statements were
issued on March 31, 1981. On January 5, 1981, the entire $300,000 balance of the 14% debentures was
refinanced by issuance of a long-term obligation. In addition, on March 1, 1981, Royal consummated a non-
cancellable agreement with the lender to refinance the 16% note payable on a long-term basis, on readily de-
cernable terms that have not yet been implemented.

Both parties are financially capable of honoring the agreement, and there have been no violations of any of
the agreement's provisions.

31. The total amount of Royal's short-term obliga-
tions that may properly be excluded from current lia-
bilities at December 31, 1980, is
a. $0
b. $30,000
c. $50,000
d. $80,000

32. Assume the same facts for Royal Corporation's liabilities, except that the agreement with the lender to
refinance the 16% note payable on a long-term basis is cancellable at any time upon ten days' notice by the
lender. The total amount of Royal's short-term obliga-
tions that may properly be excluded from current liabilities at December 31, 1980, is
a. $0
b. $30,000
c. $50,000
d. $80,000

B. Deferred Revenues

2M85#6. At December 31, 1984, Park Beauticians
had 1,000 gift certificates outstanding which had been
sold to customers during 1984 for $50 each. Park oper-
ates on a gross margin of 60%. How much revenue pertain-
ing to the 1,000 outstanding gift certificates should be deferred at December 31, 1984?

a. $50,000
b. $30,000
c. $20,000
d. $0

2M85#10. The following information pertains to
equipment sold by Bard Co. to Kerr Co. on December
31, 1984:

| Sales price | $300,000 |
| Book Value | 100,000 |
| Estimated remaining economic life | 20 years |

Simultaneously with the sale, Bard leased back the
equipment for a period of 16 years. How much of the
profit on the sale should Bard defer at December 31,
1984?

a. $200,000
b. $12,500
c. $10,000
d. $0

1N84#22. Amboy Corporation, which began business
on January 1, 1983, appropriately uses the installment
sales method of accounting for income tax reporting
purposes. The following data are available for 1983:

Installment accounts receivable, 12/31/83 $400,000
Installment sales for 1983 $700,000
Gross profit on sales 40%
Applying the installment sales method, what would be Amboy's deferred gross profit at December 31, 1983?
   a. $120,000  
   b. $160,000  
   c. $180,000  
   d. $240,000

1MB4#21. Greene Company sells office equipment service contracts agreeing to service equipment for a two-year period. Cash receipts from contracts are credited to unearned service contract revenue and service contract costs are charged to service contract expense as incurred. Revenue from service contracts is recognized as earned over the lives of the contracts. Additional information for the year ended December 31, 1983, is as follows:

   Unearned service contract revenue
       at January 1, 1983 $600,000
   Cash receipts from service contracts sold 980,000
   Service contract revenue recognized 860,000
   Service contract expense 520,000

What amount should Greene report as unearned service contract revenue at December 31, 1983?
   a. $460,000  
   b. $480,000  
   c. $490,000  
   d. $720,000

1NB3#4. Weaver Company sells magazine subscriptions for a one-year, two-year, or three-year period. Cash receipts from subscribers are credited to magazine subscriptions collected in advance, and this account had a balance of $1,700,000 at December 31, 1981. Information for the year ended December 31, 1982, is as follows:

   Cash receipts from subscribers $2,100,000
   Magazine subscriptions revenue
       (credited at 12/31/82) 1,500,000

In its December 31, 1982, balance sheet, what amount should Weaver report as the balance for magazine subscriptions collected in advance?
   a. $1,400,000  
   b. $1,900,000  
   c. $2,100,000  
   d. $2,300,000

1MB3#16. On December 31, 1982, Tower Pizza, Inc., signed an agreement authorizing Greene Company to operate as a franchisee for an initial franchise fee of $50,000. Of this amount, $20,000 was received upon signing of the agreement and the balance is due in three annual payments of $10,000 each beginning December 31, 1983. The agreement provides that the down payment (representing a fair measure of the services already performed by Tower) is not refundable and substantial future services are required of Tower. Greene's credit rating is such that collection of the note is reasonably certain. The present value at December 31, 1982, of the three annual payments discounted at 14% (the implicit rate for a loan of this type) is $23,220. On December 31, 1982, Tower should record unearned franchise fees in respect of the Greene franchise of
   a. $23,220  
   b. $30,000  
   c. $43,220  
   d. $50,000

1NB2#5. Wright Company sells for cash major household appliance service contracts agreeing to service customers' appliances for a one-year, two-year, or three-year period. Cash receipts from contracts are credited to unearned service contract revenues and this account had a balance of $1,440,000 at December 31, 1981, before year-end adjustment. Service contract costs are charged to service contract expense as incurred and this account had a balance of $360,000 at December 31, 1981. Outstanding service contracts at December 31, 1981, expire as follows:

   During 1982 — $300,000
   During 1983 — 450,000
   During 1984 — 200,000

What amount should Wright report as unearned service contract revenues at December 31, 1981?
   a. $ 490,000  
   b. $ 712,500  
   c. $ 950,000  
   d. $1,080,000

C. Deferred Income Tax Liabilities

2MB5#8. Among the items reported on Wood Corp.'s income statement for the year ended December 31, 1984, were the following:

   Interest received on municipal bonds $5,000
   Amortization of goodwill 9,000

Timing differences for interperiod tax allocation amount to
   a. $0  
   b. $ 5,000  
   c. $ 9,000  
   d. $14,000

2MB5#9. Lee Corp. uses the equity method of accounting for its 30% investment in the common stock of Gow Corp. Lee's 1984 income statement reported investment income of $90,000 from Gow. During 1984 Lee received $20,000 in dividends from Gow, which were eligible for the 85% dividends-received deduction for tax purposes. Assuming an income tax rate of 40%, how much should Lee credit to deferred income taxes?
   a. $0  
   b. $1,200  
   c. $4,200  
   d. $5,400
1N84#23. Dugan Corporation, which began operations on January 1, 1981, recognizes income from long-term construction contracts under the percentage-of-completion method in its financial statements but uses the completed-contract method for income tax reporting. Reported income from long-term construction contracts under each method is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of completion</th>
<th>Completed contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>$400,000</td>
<td>$0</td>
</tr>
<tr>
<td>1982</td>
<td>650,000</td>
<td>350,000</td>
</tr>
<tr>
<td>1983</td>
<td>950,000</td>
<td>750,000</td>
</tr>
</tbody>
</table>

For all years, the effective income tax rate is 40% and there are no other timing differences. In its December 31, 1983, balance sheet, Dugan should report a liability for deferred taxes of

a. $80,000
b. $160,000
c. $200,000
d. $360,000

1M84#23. On January 1, 1983, Wolfe Company purchased a building for $1,500,000. The building will be depreciated $50,000 per year by the straight-line method for financial statement reporting. For income tax reporting, Wolfe uses the ACRS and will be allowed a cost recovery deduction of $180,000 for 1983. Assuming an income tax rate of 40%, what amount of deferred income taxes should be added to Wolfe’s deferred income tax liability at December 31, 1983?

a. $52,000
b. $72,000
c. $78,000
d. $130,000

1N83#29. On December 20, 1982, Sussex Corporation received a condemnation award of $300,000 as compensation for the forced sale of a company plant with a book value of $200,000. In its income tax return for the year ended December 31, 1982, Sussex elected to replace the condemned plant within the allowed replacement period. Accordingly, the $100,000 gain was not reported as taxable income for 1982. Sussex has an effective income tax rate of 40% for 1982. In its December 31, 1982, balance sheet, what amount should Sussex report as a liability for deferred taxes on the above gain?

a. $60,000
b. $40,000
c. $20,000
d. $0

1N83#31. Martin Company began operations on January 1, 1981, and a substantial part of its sales are made on an installment basis. For financial reporting Martin recognizes revenues from all sales under the accrual method. However, on its income tax returns, Martin reports revenues from installment sales under the installment method. Information concerning gross profit from installment sales under each method is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Accrual method</th>
<th>Installment method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>$400,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>1982</td>
<td>650,000</td>
<td>350,000</td>
</tr>
</tbody>
</table>

For both years, assume the effective income tax rate is 40% and there are no other timing differences. In its December 31, 1982, balance sheet, Martin should report a liability for deferred taxes of

a. $220,000
b. $200,000
c. $180,000
d. $120,000

1M83#12. Saratoga, Inc., owns 75% of the voting common stock of its domestic subsidiary, Bell Corporation. During 1982 Bell reported earnings of $150,000 and paid dividends of $50,000. Saratoga assumes that all of the undistributed earnings of Bell will be distributed as dividends in future periods. Assuming that Saratoga’s income tax rate is 40%, the amount of deferred tax to be reported for 1982 is

a. $4,500
b. $6,750
c. $30,000
d. $40,000

2M81#33. On January 2, 1978, Gow Corporation bought a press for $22,000, with an estimated useful life of four years and a salvage value of $6,000. Straight-line depreciation is used for financial statement purposes and the sum-of-the-years’-digits method is used for income tax purposes. Assuming an income tax rate of 50%, and no other timing differences, what amount should be reported in the balance sheet as deferred income taxes at December 31, 1980?

a. $400 debit.
b. $1,200 credit.
c. $1,600 credit.
d. $2,400 credit.

D. Capitalized Lease Liability

1M84#24. On December 31, 1982, Kern Company leased a machine from Woods Company for a ten-year period expiring December 30, 1992. Equal annual payments under the lease are $50,000 and are due on December 31 of each year. The first payment was made on December 31, 1982, and the second payment was made on December 31, 1983. The present value at December 31, 1982, of the ten lease payments over the lease term discounted at 10% was $338,000. The lease is appropriately accounted for as a capital lease by
Kern. In its December 31, 1983, balance sheet Kern should report the capitalized lease liability at
a. $243,000
b. $259,200
c. $266,800
d. $400,000

1N83#33. On December 31, 1982, Jackson Company leased a new machine from Nash Corporation. The following information relates to the lease transaction:

- The machine has an estimated useful life of seven years which coincides with the lease term.
- Lease rentals consist of seven equal annual payments of $100,000, the first of which was paid on December 31, 1982.
- Nash's implicit interest rate is 12%, which is known by Jackson.
- Jackson's incremental borrowing rate is 14% at December 31, 1982.
- Present value of an annuity of $1 in advance for seven periods at 12% is 5.11.
- Present value of an annuity of $1 in advance for seven periods at 14% is 4.89.

At the inception of the lease, Jackson should record a capitalized lease liability of
a. $389,000
b. $489,000
c. $500,000
d. $511,000

1N82#1. Star Company leased a new machine from Fox Company on December 31, 1981, under a lease with the following pertinent information:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term</td>
<td>10 years</td>
</tr>
<tr>
<td>Annual rental payable at the beginning of each year</td>
<td>$200,000</td>
</tr>
<tr>
<td>Useful life of the machine</td>
<td>15 years</td>
</tr>
<tr>
<td>Implicit interest rate</td>
<td>10%</td>
</tr>
<tr>
<td>Present value of an annuity of $1 in advance for 10 periods at 10%</td>
<td>6.76</td>
</tr>
<tr>
<td>Present value of $1 for 10 periods at 10%</td>
<td>0.39</td>
</tr>
</tbody>
</table>

Star has the option to purchase the machine on December 31, 1991, by paying $250,000, which is significantly less than the $500,000 expected fair market value of the machine on the option exercise date. Assume that, at the inception of the lease, the exercise of the option appears to be reasonably assured. At the inception of the lease, Star should record a capitalized lease liability of
a. $1,254,500
b. $1,352,000
c. $1,449,500
d. $1,547,000

1N82#8. Harris, Inc., leased equipment under a capital lease for a period of seven years, contracting to pay $100,000 rent in advance at the start of the lease term on December 31, 1980, and $100,000 annually on December 31 of each of the next six years. The present value at December 31, 1980, of the seven rent payments over the lease term discounted at 10% (the implicit interest rate) was $535,000. Harris amortizes its liability under capital lease using the effective interest method. In its December 31, 1981, balance sheet, Harris should report a liability under capital lease of
a. $378,500
b. $391,500
c. $437,350
d. $500,000

1M82#8. Bond Company leased equipment from Howe, Inc., on December 31, 1980, for a ten-year period (the useful life of the asset) expiring December 30, 1990. 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, 1980, and the second payment was made on the due date. The present value at December 31, 1980, of the minimum lease payments over the lease term discounted at 10% (the implicit rate computed by Howe and known by Bond) was $676,000. Bond's incremental borrowing rate was 12% at December 31, 1980. The lease is appropriately accounted for as a capital lease by Bond. What should be the balance in Bond's liability under capital lease account at December 31, 1981?
   a. $533,600
   b. $545,120
   c. $607,960
   d. $800,000

E. Bonds Payable

2M85#4. Kork Corp. had the following long-term debt at December 31, 1984:

- Collateral trust bonds, having securities of unrelated corporations as security $500,000
- Bonds unsecured as to principal 300,000

The debenture bonds amounted to
a. $0
b. $300,000
c. $500,000
d. $800,000

2M85#5. The following costs were incurred in connection with the issuance of bonds by Hub Corp.:

- Printing and engraving $  5,000
- Legal and accounting  100,000
- Commissions  180,000

AP-29
How much should be treated as a deferred charge to be amortized over the life of the debt?

a. $ 5,000  
   b. $100,000  
   c. $280,000  
   d. $285,000

1N84#24. On December 31, 1982, Arnold, Inc., issued $200,000, 8% serial bonds, to be repaid in the amount of $40,000 each year. Interest is payable annually on December 31. The bonds were issued to yield 10% a year. The bond proceeds were $190,280 based on the present values at December 31, 1982, of the five annual payments as follows:

<table>
<thead>
<tr>
<th>Due date</th>
<th>Amounts due</th>
<th>Present value at 12/31/82</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/83</td>
<td>Principal</td>
<td>$40,000</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>$16,000</td>
</tr>
<tr>
<td>12/31/84</td>
<td>Principal</td>
<td>$40,000</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>$12,800</td>
</tr>
<tr>
<td>12/31/85</td>
<td>Principal</td>
<td>$40,000</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>$9,600</td>
</tr>
<tr>
<td>12/31/86</td>
<td>Principal</td>
<td>$40,000</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>$6,400</td>
</tr>
<tr>
<td>12/31/87</td>
<td>Principal</td>
<td>$40,000</td>
</tr>
<tr>
<td></td>
<td>Interest</td>
<td>$3,200</td>
</tr>
</tbody>
</table>

Arnold amortizes the bond discount by the interest method. In its December 31, 1983, balance sheet, at what amount should Arnold report the carrying value of the bonds?

a. $139,380  
   b. $149,100  
   c. $150,280  
   d. $153,308

1M84#25. On June 30, 1983, Dean Company had outstanding 8%, $1,000,000 face value, 15-year bonds maturing on June 30, 1993. Interest is payable on June 30 and December 31. The unamortized balances on June 30, 1983, in the bond discount and deferred bond issue costs accounts were $45,000 and $15,000, respectively. Dean reacquired all of these bonds at 93 on June 30, 1983, and retired them. Ignoring income taxes, how much gain should Dean report on this early extinguishment of debt?

a. $10,000  
   b. $25,000  
   c. $40,000  
   d. $70,000

1M84#30. On March 1, 1984, Riley Corporation issued $1,000,000 of 10% nonconvertible bonds at 103 which are due on February 28, 1999. In addition, each $1,000 bond was issued with 30 detachable stock warrants, each of which entitled the bondholder to purchase, for $50, one share of Riley common stock, par value $25. On March 1, 1984, the quoted market value of Riley's common stock was $40 per share and the quoted market value of each warrant was $4. What amount of the proceeds from the bond issue should Riley record as an increase in stockholders' equity?

a. $0  
   b. $30,000  
   c. $120,000  
   d. $750,000

1N84#40. On June 30, 1983, Harper, Inc., had outstanding 8%, $1,000,000 face value, convertible bonds maturing on June 30, 1988. Interest is payable on June 30 and December 31. The unamortized balance in the bond premium account was $50,000 on June 30, 1983. On this date all of these bonds were converted into 40,000 shares of $20 par value common stock. Harper incurred expenses of $30,000 in connection with the conversion. Under the book value method, the total amount by which additional paid-in capital should increase is

a. $180,000  
   b. $200,000  
   c. $220,000  
   d. $250,000

1N83#2. On January 1, 1982, Hansen, Inc., issued for $939,000 one thousand of its 9%, $1,000 bonds. The bonds were issued to yield 10%. The bonds are dated January 1, 1982, and mature on December 31, 1991. Interest is payable annually on December 31. Hansen uses the interest method of amortizing bond discount. In its December 31, 1982, balance sheet, Hansen should report unamortized bond discount of

a. $57,100  
   b. $54,900  
   c. $51,610  
   d. $51,000

1N83#5. On April 1, 1983, Girard Corporation issued at 98 plus accrued interest, two hundred of its 10%, $1,000 bonds. The bonds are dated January 1, 1983, and mature on January 1, 1993. Interest is payable semiannually on January 1 and July 1. From the bond issuance Girard would realize net cash receipts of

a. $191,000  
   b. $196,000  
   c. $198,500  
   d. $201,000

1N83#7. On January 1, 1975, Gilson Corporation issued for $1,030,000, one thousand of its 9%, $1,000 callable bonds. The bonds are dated January 1, 1975, and mature on December 31, 1989. Interest is payable semiannually on January 1 and July 1. The bonds can be called by the issuer at 102 on any interest payment date after December 31, 1979. The unamortized bond premium was $14,000 at December 31, 1982, and the market price of the bonds was 99 on this date. In its December 31, 1982, balance sheet, at what amount should Gilson report the carrying value of the bonds?

a. $1,020,000  
   b. $1,016,000  
   c. $1,014,000  
   d. $990,000
1M83#8. On December 31, 1981, Dumont Corporation had outstanding 8%, $2,000,000 face value convertible bonds maturing on December 31, 1985. Interest is payable annually on December 31. Each $1,000 bond is convertible into 60 shares of Dumont’s $10 par value common stock. The unamortized balance on December 31, 1982, in the premium on bonds payable account was $45,000. On December 31, 1982, an individual holding 200 of the bonds exercised the conversion privilege when the market value of Dumont’s common stock was $18 per share. Using the book value method, Dumont’s entry to record the conversion should include a credit to additional paid-in capital of
a. $80,000  
b. $84,500  
c. $96,000  
d. $125,000

1M83#11. On July 1, 1976, Belmont Corporation issued for $960,000, one thousand of its 9%, $1,000 callable bonds. The bonds are dated July 1, 1976, and mature on July 1, 1986. Interest is payable semiannually on January 1 and July 1. Belmont 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, 1981.

On July 1, 1982, Belmont called in all of the bonds and retired them. Ignoring income taxes, how much loss should Belmont report on this early extinguishment of debt for the year ended December 31, 1982?

a. $50,000  
b. $34,000  
c. $26,000  
d. $10,000

1M83#19. On January 1, 1982, Jaffe Corporation issued at 95, five hundred of its 9%, $1,000 bonds. Interest is payable semiannually on July 1 and January 1, and the bonds mature on January 1, 1992. Jaffe paid bond issue costs of $20,000 which are appropriately recorded as a deferred charge. Jaffe uses the straight-line method of amortizing bond discount and bond issue costs. On Jaffe’s December 31, 1982, balance sheet, the bonds payable should be reported at their carrying value of
a. $459,500  
b. $477,500  
c. $495,500  
d. $522,500

2M83#20. On June 4, 1982, Xmar Corporation sold $200,000 face amount of 12% bonds for $198,000, with interest payable semiannually beginning December 3, 1982. Each $1,000 bond had ten detachable warrants entitling the holder to buy one share of Xmar’s common stock for each warrant surrendered, plus $20 cash. Shortly after the bonds were sold, each bond was selling for $1,000 without the warrants, while the warrants were selling for $10 each. What portion of the $198,000 proceeds should be credited to “Additional paid-in capital — warrants”?

a. $0  
b. $2,000  
c. $18,000  
d. $20,000

2N82#7. On January 1, 1976, Roper Corporation issued 2,000 of its 10%, $1,000 bonds for $2,080,000. These bonds were to mature on January 1, 1986, but were callable at 101 any time after December 31, 1980. Interest was payable semiannually on July 1 and January 1. On July 1, 1981, Roper called all of the bonds and retired them. Bond premium was amortized on a straight-line basis. Ignoring income taxes, how much was Roper’s gain or loss in 1981 on this early extinguishment of debt?

a. $16,000 gain.  
b. $20,000 loss.  
c. $24,000 gain.  
d. $60,000 gain.

2N82#14. On July 1, 1982, Glendora Corporation issued $1,000,000 of 10% nonconvertible bonds at 103, due June 30, 2002. Each $1,000 bond was issued with 30 detachable stock warrants, each of which entitled the bondholder to buy one share of Glendora’s $10 par value common stock for $25. On July 1, 1982, the market values of Glendora’s common stock and warrants were $30 and $4, respectively. How much should Glendora record on July 1, 1982, as paid-in capital from stock warrants?

a. $30,000  
b. $120,000  
c. $150,000  
d. $300,000

2N82#20. On July 1, 1982, Menzie Corporation sold a $1,000,000, 20-year, 10% bond issue for $1,060,000. Each $1,000 bond had a detachable warrant eligible for the purchase of one share of Menzie’s $50 par value common stock for $60. Immediately after sale of the bonds, Menzie’s securities had the following market values:

| 10% bond without warrants | $1,040 |
| Warrants                  | 20    |
| Common stock, $50 par value | 56    |

How much should Menzie credit to premium on bonds payable?

a. $0  
b. $20,000  
c. $40,000  
d. $60,000

2M82#15. On January 1, 1981, when the market rate for bond interest was 14%, Luba Corporation issued bonds in the face amount of $500,000, with interest at 12% payable semiannually. The bonds mature on De-
December 31, 1990, and were issued at a discount of $53,180. How much of the discount should be amortized by the interest method at July 1, 1981?

1. $1,277
2. $2,659
3. $3,191
4. $3,723

F. Contingent Liabilities and Commitments

1N81#8. On December 31, 1979, Livonia Corporation had outstanding 7%, $2,000,000 face value, 15-year bonds maturing on December 31, 1989. Interest is payable on June 30 and December 31. The unamortized balances on December 31, 1979, in the premium on bonds payable and deferred bond interest costs accounts were $50,000 and $25,000, respectively. Livonia reacquired all of these bonds at 95 on December 31, 1980. Livonia uses the straight-line method for the amortization of bond premium and bond issue costs. Ignoring income taxes, what is the amount of gain or loss that Livonia should report on this early extinguishment of debt in its income statement for the year ended December 31, 1980?

2. $122,500 gain.
3. $122,500 loss.
4. $167,500 gain.
5. $167,500 loss.

2N81#29. On March 1, 1981, Harbour Corporation issued 10% debentures dated January 1, 1981, in the face amount of $1,000,000, with interest payable on January 1 and July 1. The debentures were sold at par and accrued interest. How much should Harbour debit to cash on March 1, 1981?

1. $966,667
2. $983,333
3. $1,016,667
4. $1,033,333

1M81#16. On January 1, 1980, Battle Corporation sold at 97 plus accrued interest, two hundred of its 8%, $1,000 bonds. The bonds are dated October 1, 1979, and mature on October 1, 1989. Interest is payable semiannually on April 1 and October 1. Accrued interest for the period October 1, 1979, to January 1, 1980, amounted to $4,000. As a result, on January 1, 1980, Battle would record bonds payable, net of discount, at

1. $190,000
2. $194,000
3. $196,000
4. $198,000

2M81#21. Elba Corporation issued $200,000 face amount of 8% bonds with interest payable on April 1 and October 1. The bonds were callable at 105. Interest and amortization of bond discount have been accounted for up to October 1, 1980, at which date the bonds were called. Unamortized bond discount on that date amounted to $16,000. Ignoring the income tax effect, what was Elba’s gain or loss on the bond retirement?

1. $6,000 gain.
2. $6,000 loss.
3. $10,000 loss.
4. $26,000 loss.

1N84#25. Day Company carries a $10,000,000 comprehensive public liability policy which has a $100,000 deductible clause. A personal injury liability suit was brought against Day in 1983. Day’s counsel believes it is probable that the suit will be settled out of court for an estimated amount of $150,000. In its December 31, 1983, balance sheet, Day should report an accrued liability of

1. $0
2. $50,000
3. $100,000
4. $150,000

1M84#26. On December 31, 1983, Jordan Company was involved in a tax dispute with the IRS. Jordan’s tax counsel believed that an unfavorable outcome was probable and a reasonable estimate of additional taxes was $400,000, with a chance that the additional taxes could be as much as $650,000. After the 1983 financial statements were issued, Jordan accepted an IRS settlement offer of $450,000. What amount of additional taxes should have been charged to income in 1983?

1. $0
2. $400,000
3. $450,000
4. $650,000

1M83#10. Starr Trading Stamp Company records stamp service revenue and provides for the cost of redemptions in the year stamps are furnished to licensees. Starr’s past experience indicates that only 90% of the
stamps sold to licensees will be redeemed. Starr's liability for stamp redemptions was $18,000,000 at December 31, 1981. Additional information for 1982 is as follows:

<table>
<thead>
<tr>
<th>Stamp service revenue from stamps furnished to licensees</th>
<th>$10,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of redemptions</td>
<td>$8,500,000</td>
</tr>
</tbody>
</table>

Estimated cost of future redemptions as a percentage of stamps redeemable, 60%

What amount should Starr report as a liability for stamp redemptions at December 31, 1982?

- $9,500,000  
- $14,900,000  
- $18,500,000  
- $19,500,000

2N83#8. On March 1, 1982, a suit was filed against Dean Company for patent infringement. Dean's legal counsel believes an unfavorable outcome is probable, and estimates that Dean will have to pay between $500,000 and $900,000 in damages. However, Dean's legal counsel is of the opinion that $600,000 is a better estimate than any other amount in the range. The situation was unchanged when the December 31, 1982, financial statements were released on February 24, 1983. How much of a liability should Dean report on its balance sheet at December 31, 1982, in connection with this suit?

- $0  
- $500,000  
- $600,000  
- $900,000

1N82#7. In an effort to increase sales, Mills Company inaugurated a sales promotion campaign on June 30, 1981. Mills placed a coupon redeemable for a premium in each package of cereal sold. Each premium costs Mills $1 and five coupons must be presented by a customer to receive a premium. Mills estimated that only 60% of the coupons issued will be redeemed. For the six months ended December 31, 1981, the following information is available:

<table>
<thead>
<tr>
<th>Packages of cereal sold</th>
<th>Premiums purchased</th>
<th>Coupons redeemed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,600,000</td>
<td>120,000</td>
<td>400,000</td>
</tr>
</tbody>
</table>

What is the estimated liability for premium claims outstanding at December 31, 1981?

- $80,000  
- $112,000  
- $144,000  
- $192,000

1N81#10. Blake Foods Corporation mails coupons to consumers which may be presented by a stated expiration date at retail food stores to obtain discounts on certain Blake products. Retailers are reimbursed for the face value of coupons redeemed, plus 10% of coupon value as compensation for handling costs. Blake honors requests for coupon redemption by retailers received up to three months after the consumer expiration date. In Blake's experience, 60% of the coupons issued ultimately are redeemed. Information with respect to the two separate series of coupons issued by Blake during 1980 is as follows:

<table>
<thead>
<tr>
<th>Series A</th>
<th>Series B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer expiration date</td>
<td>June 30, 1980</td>
</tr>
<tr>
<td>Total face value of coupons issued</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total payments to retailers as of December 31, 1980</td>
<td>$60,500</td>
</tr>
</tbody>
</table>

What amount should Blake report as a liability for unredeemed coupons at December 31, 1980?

- $0  
- $79,500  
- $91,500  
- $97,000

2N82#15. Warren Waste Products Company carries a $5,000,000 comprehensive public liability policy which contains a $50,000 deductible clause. A personal injury liability suit was brought against Warren in 1981, which probably will be settled for $75,000. How much should appear on Warren's December 31, 1981, balance sheet for contingent liabilities?

- $0  
- $25,000  
- $50,000  
- $75,000

2N81#12. On January 10, 1981, an explosion and fire occurred at Staren Chemical Corporation's plant, causing extensive property damage to neighboring buildings. On March 1, 1981, Staren's management and attorneys concluded that $2,000,000 would be a reasonable estimate of liability for damages, although no claims had yet been asserted against Staren in connection with the accident. Of the $2,000,000 potential liability, only $500,000 was covered by insurance. In Staren's December 31, 1980, financial statements, which were issued on April 1, 1981, how should this item be reported?

- As a footnote disclosure indicating the possible loss of $1,500,000.  
- As an accrued liability of $1,500,000, with a corresponding direct charge to retained earnings.  
- As an accrued liability of $2,000,000, with a corresponding charge to income.  
- As an accrued liability of $1,500,000, with a corresponding charge to income.
At the end of its year, Fulton recognized a liability equal to the estimated cost of potential prizes outstanding. What is the amount of this estimated liability?

- $4,000
- $16,000
- $18,000
- $42,000

### IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

#### A. Preferred and Common Stock

**1M85**

Items 14 and 15 are based on the following data:

- **Frey, Inc.**
  
  Frey, Inc., was organized on January 2, 1984, with the following capital structure:

  - 10% cumulative preferred stock, par value $100 and liquidation value $105; authorized, issued and outstanding 1,000 shares
  
  - Common stock, par value $25; authorized 100,000 shares; issued and outstanding 10,000 shares

  Frey's net income for the year ended December 31, 1984, was $450,000, but no dividends were declared.

- **1N84#26.** Cronin Corporation was organized on January 3, 1983, with authorized capital of 50,000 shares of $10 par value common stock. During 1983 Cronin had the following transactions affecting stockholders' equity:
  
  - **January 7 — Issued 20,000 shares @ $12 per share**
  - **December 2 — Purchased 3,000 shares of treasury stock @ $13 per share**

  The cost method was used to record the treasury stock transaction. Cronin's net income for 1983 is $150,000. What is the amount of stockholder's equity at December 31, 1983?
  
  - $320,000
  - $351,000
  - $354,000
  - $360,000

- **1N84#27.** Jason Corporation's stockholders' equity at December 31, 1983, consisted of the following:
  
  - Preferred stock, $50 par value, 10% noncumulative; 10,000 shares issued and outstanding
  
  - Common stock, $10 par value: 80,000 shares issued and outstanding
  
  Retained earnings

  The preferred stock has a liquidating value of $55 per share. At December 31, 1983, the book value per share of common stock is
  
  - $14.38
  - $13.75
  - $13.13
  - $10.00
Selected Questions

2M83#34. The stockholders' equity section of Peter Corporation's balance sheet at December 31, 1982, was as follows:

<table>
<thead>
<tr>
<th></th>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$900,000</td>
<td>$1,300,000</td>
</tr>
<tr>
<td>b.</td>
<td>$1,400,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>c.</td>
<td>$1,900,000</td>
<td>$1,300,000</td>
</tr>
<tr>
<td>d.</td>
<td>$2,400,000</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

On January 2, 1983, Peter purchased and retired 100,000 shares of its stock for $1,800,000. Immediately after retirement of these 100,000 shares, the balances in the additional paid-in capital and retained earnings accounts should be

2M81#20. Maple Corporation's stockholders' equity at June 30, 1980, consisted of the following:

- Preferred stock, 10%, $50 par value; liquidating value $55 per share; 20,000 shares issued and outstanding $1,000,000
- Common stock, $10 par value; 500,000 shares authorized; 150,000 shares issued and outstanding 1,500,000
- Retained earnings 500,000

The book value per share of common stock is

a. $10.00
b. $12.67
c. $13.33
d. $17.65

2M81#22. Pine Corporation's stockholders' equity at December 31, 1980, consisted of the following:

- Cumulative preferred stock, 6%, $100 par value; 1,000 shares issued and outstanding $100,000
- Common stock, $10 par value; 300,000 shares authorized; 50,000 shares issued and outstanding 500,000
- Retained earnings 90,000

Dividends have not been declared on the preferred stock for the years 1976 through 1980. The book value per share of common stock is

a. $10.00
b. $11.20
c. $11.80
d. $14.12

B. Additional Paid-In Capital

1M85#16. Landy Corporation was organized on January 2, 1984, with authorized capital of 100,000 shares of $10 par value common stock. During 1984, Landy had the following transactions:

- January 12 — Issued 20,000 shares at $12 per share
- April 23 — Issued 1,000 shares for legal services when the market price was $14 per share

What should be the amount of additional paid-in capital at December 31, 1984?

a. $4,000
b. $14,000
c. $40,000
d. $44,000

2N81#21. Goodel Corporation was organized on January 1, 1980, with authorized capital of 500,000 shares
of $10 par value common stock. During 1980, Goodel had the following transactions affecting stockholders' equity:

January 10 — Issued 10,000 shares @ $12 per share
May 8 — Purchased 1,000 shares of treasury stock @ $13 per share
September 10 — Sold 1,000 shares of treasury stock @ $14 per share

Goodel used the cost method for recording treasury stock transactions. What is the amount of additional paid-in capital at December 31, 1980?

a. $0
b. $ 1,000
c. $20,000
d. $21,000

2N81#22. On July 14, 1981, JX Corporation exchanged 1,000 shares of its $8 par value common stock for a plot of land. JX's common stock is listed on the NYSE and traded at an average price of $21 per share on July 14. The land was appraised by independent real estate appraisers on July 14 at $23,000. As a result of this exchange, JX's additional paid-in capital will increase by

a. $0
b. $ 8,000
c. $13,000
d. $15,000

C. Retained Earnings and Dividends

1M85#17. Terry, Inc., is a calendar-year corporation whose financial statements for 1983 and 1984 included errors as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Ending inventory</th>
<th>Depreciation expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>$15,000 overstated</td>
<td>$12,500 overstated</td>
</tr>
<tr>
<td>1984</td>
<td>5,000 understated</td>
<td>4,000 understated</td>
</tr>
</tbody>
</table>

Assume that purchases were recorded correctly and that no correcting entries were made at December 31, 1983, or at December 31, 1984. Ignoring income taxes, by how much should Terry's retained earnings be retroactively adjusted at January 1, 1985?

a. $13,500 increase.
b. $ 3,500 decrease.
c. $ 1,500 decrease.
d. $ 1,000 increase.

1M85#18. On December 31, 1984, the stockholders' equity section of Bergen, Inc., was as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, par value $10; authorized 30,000 shares; issued and outstanding 9,000 shares</td>
<td>$ 90,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>116,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>146,000</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td><strong>$352,000</strong></td>
</tr>
</tbody>
</table>

On March 31, 1985, Bergen declared a 10% stock dividend, and accordingly 900 additional shares were issued, when the fair market value of the stock was $16 per share. For the three months ended March 31, 1985, Bergen sustained a net loss of $32,000. The balance of Bergen's retained earnings as of March 31, 1985, should be

a. $ 99,600
b. $105,000
c. $108,600
d. $114,000

1M85#24. Clay, Inc., owned 10,000 common shares of Dart Corporation purchased in 1980 for $90,000. On September 20, 1984, Clay declared a property dividend of one share of Dart for every five shares of Clay common stock held by a stockholder. On that date there were 50,000 common shares of Clay outstanding, and the market price of Dart shares was $15 per share. The entry to record the declaration of the property dividend would include a debit to retained earnings of

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

1N84#28. On January 2, 1984, the board of directors of Blake Mining Corporation declared a cash dividend of $800,000 to stockholders of record on January 18, 1984, and payable on February 10, 1984. The dividend is permissible under state law in Blake's state of incorporation. Selected data from Blake's December 31, 1983, balance sheet are as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated depletion</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Capital stock</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>300,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>600,000</td>
</tr>
</tbody>
</table>

The $800,000 dividend includes a liquidating dividend of

a. $600,000
b. $300,000
c. $200,000
d. $0

1N84#29. After the issuance of its 1982 financial statements Terry, Inc., discovered a computational error of $150,000 in the calculation of its December 31, 1982, inventory. The error resulted in a $150,000 overstate-
Selected Questions

1N82#9. On September 30, 1982, Grey Company issued 3,000 shares of its $10 par common stock in connection with a stock dividend. No entry was made on the stock dividend declaration date. The market value per share immediately after issuance was $15. Grey's stockholders' equity accounts immediately before issuance of the stock dividend shares were as follows:

<table>
<thead>
<tr>
<th>Common stock, $10 par; 50,000 shares authorized; 20,000 shares outstanding</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>300,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>350,000</td>
</tr>
</tbody>
</table>

What should be the retained earnings balance immediately after the stock dividend?

a. $305,000  
b. $320,000  
c. $327,500  
d. $350,000

2N82#1. Anton Corporation's retained earnings at December 31, 1981, amounted to $1,000,000. On that date Anton declared a property dividend. The property to be distributed had a carrying value of $100,000 and a fair market value of $180,000 at the declaration date. How much gain should Anton recognize as a result of this distribution?

a. $0  
b. $80,000  
c. $100,000  
d. $180,000

1N81#11. Effective April 27, 1981, the stockholders of Bennett Corporation approved a two-for-one 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). Bennett's stockholders' equity accounts immediately before issuance of the stock split shares were as follows:

<table>
<thead>
<tr>
<th>Common stock, par value $20; 100,000 shares authorized; 50,000 shares outstanding</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital (premium of $3 per share on issuance of common stock)</td>
<td>150,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,350,000</td>
</tr>
</tbody>
</table>

What should be the balances in Bennett's additional paid-in capital and retained earnings accounts immediately after the stock split is effected?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$500,000</td>
</tr>
<tr>
<td>b. $150,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>c. $150,000</td>
<td>$1,350,000</td>
</tr>
<tr>
<td>d. $1,150,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

Olsen ascertains year-end quantities on a periodic inventory system. These quantities are converted to dollar amounts using the FIFO cost flow method. Assuming no other accounting errors, Olsen's retained earnings at December 31, 1982, will be

a. Correct  
b. $60,000 understated  
c. $60,000 overstated  
d. $110,000 understated

1N83#8. During 1983, Olsen Company discovered that the ending inventories reported on its financial statements were understated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Understatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>$50,000</td>
</tr>
<tr>
<td>1981</td>
<td>$60,000</td>
</tr>
<tr>
<td>1982</td>
<td>$0</td>
</tr>
</tbody>
</table>

1N83#6. The following information pertains to a property dividend of marketable securities, declared by Tyson Corp.:

<table>
<thead>
<tr>
<th></th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Declaration date—December 20, 1982</td>
<td>$300,000</td>
</tr>
<tr>
<td>Record date—January 10, 1983</td>
<td>310,000</td>
</tr>
<tr>
<td>Distribution date—January 28, 1983</td>
<td>305,000</td>
</tr>
</tbody>
</table>

Carrying value of the securities on Tyson's books was $200,000. How much gain should Tyson recognize in 1982 as a result of this property dividend?

a. $0  
b. $100,000  
c. $105,000  
d. $110,000

2N83#5. During 1983, Olsen Company discovered that the ending inventories reported on its financial statements were understated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Understatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>$50,000</td>
</tr>
<tr>
<td>1981</td>
<td>$60,000</td>
</tr>
<tr>
<td>1982</td>
<td>$0</td>
</tr>
</tbody>
</table>

1N84#32. On June 30, 1984, Gilman, Inc., declared and issued a 10% common stock dividend. Prior to this dividend, Gilman had 20,000 shares of $10 par value common stock issued and outstanding. The market price of Gilman's common stock on June 30, 1984, was $24 per share. As a result of this stock dividend, by what amount should Gilman's total stockholders' equity increase (decrease)?

a. $0  
b. $20,000  
c. $28,000  
d. $(48,000)

1N82#9. On September 30, 1982, Grey Company issued 3,000 shares of its $10 par common stock in connection with a stock dividend. No entry was made on the stock dividend declaration date. The market value per share immediately after issuance was $15. Grey's stockholders' equity accounts immediately before issuance of the stock dividend shares were as follows:

<table>
<thead>
<tr>
<th>Common stock, $10 par; 50,000 shares authorized; 20,000 shares outstanding</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>300,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>350,000</td>
</tr>
</tbody>
</table>

What should be the retained earnings balance immediately after the stock dividend?

a. $305,000  
b. $320,000  
c. $327,500  
d. $350,000

2N82#1. Anton Corporation's retained earnings at December 31, 1981, amounted to $1,000,000. On that date Anton declared a property dividend. The property to be distributed had a carrying value of $100,000 and a fair market value of $180,000 at the declaration date. How much gain should Anton recognize as a result of this distribution?

a. $0  
b. $80,000  
c. $100,000  
d. $180,000

1N81#11. Effective April 27, 1981, the stockholders of Bennett Corporation approved a two-for-one 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). Bennett's stockholders' equity accounts immediately before issuance of the stock split shares were as follows:

<table>
<thead>
<tr>
<th>Common stock, par value $20; 100,000 shares authorized; 50,000 shares outstanding</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital (premium of $3 per share on issuance of common stock)</td>
<td>150,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,350,000</td>
</tr>
</tbody>
</table>

What should be the balances in Bennett's additional paid-in capital and retained earnings accounts immediately after the stock split is effected?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$500,000</td>
</tr>
<tr>
<td>b. $150,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>c. $150,000</td>
<td>$1,350,000</td>
</tr>
<tr>
<td>d. $1,150,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>
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2N81#18. George Corporation declared a cash dividend of $10,000 on January 17, 1981. This dividend was payable to stockholders of record on February 10, 1981, and payment was made on March 2, 1981. As a result of this cash dividend, working capital will increase (decrease) on

<table>
<thead>
<tr>
<th>January 17</th>
<th>February 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $10,000</td>
<td>$0</td>
</tr>
<tr>
<td>c. $(10,000)</td>
<td>$0</td>
</tr>
<tr>
<td>d. $(10,000)</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

2N81#19. Doe Corporation owned 1,000 shares of Spun Corporation. These shares were purchased in 1977 for $9,000. On September 15, 1981, Doe declared a property dividend of one share of Spun for every ten shares of Doe held by a stockholder. On that date, when the market price of Spun was $14 per share, there were 9,000 shares of Doe outstanding. What gain and net reduction in retained earnings would result from this property dividend?

<table>
<thead>
<tr>
<th>Gain</th>
<th>Net reduction in retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$8,100</td>
</tr>
<tr>
<td>b. $0</td>
<td>$12,600</td>
</tr>
<tr>
<td>c. $4,500</td>
<td>$3,600</td>
</tr>
<tr>
<td>d. $4,500</td>
<td>$8,100</td>
</tr>
</tbody>
</table>

2N81#38. On July 1, 1981, Boulevard Corporation split its common stock 4 for 1, when the market value was $80 per share. Prior to the split, Boulevard had 50,000 shares of $12 par value common stock issued and outstanding. After the split, the par value of the stock

a. Remained the same.
b. Was reduced by $3 per share.
c. Was reduced to $3 per share.
d. Was reduced by $4 per share.

D. Treasury Stock and Other Contra Accounts

1M85#25. Beal Corporation holds 5,000 shares of its $10 par value common stock as treasury stock, which was purchased in 1982 at a cost of $60,000. On December 10, 1984, Beal sold all 5,000 shares for $95,000. Assuming that Beal used the cost method of accounting for treasury stock, this sale would result in a credit to

a. Additional paid-in capital of $35,000.
b. Gain on sale of investments of $35,000.
c. Retained earnings of $35,000.
d. Capital stock of $50,000.

1M83#15. Victor Corporation was organized on January 2, 1982, with 100,000 authorized shares of $10 par value common stock. During 1982 Victor had the following capital transactions:

- January 5—issued 75,000 shares at $14 per share.
- December 27—purchased 5,000 shares at $11 per share.

Victor used the par value method to record the purchase of the treasury shares. What would be the balance in the paid-in capital from treasury stock account at December 31, 1982?

| a. $0 |
| b. $5,000 |
| c. $15,000 |
| d. $20,000 |

1N82#10. The stockholders' equity account balances of Rice Corporation as of December 31, 1981, are as follows:

- Common stock, $10 par; 50,000 shares authorized; 25,000 shares issued $250,000
- Paid-in capital in excess of par 50,000
- Retained earnings 100,000
- Less treasury stock, 2,000 shares at cost (32,000)
- Total stockholders' equity $368,000

On January 4, 1982, Rice sold the treasury shares on the open market at $20 per share. The entry to record this sale on Rice's books should include a credit to

a. Gain from sale of treasury stock of $8,000.
b. Paid-in capital from treasury stock of $8,000.
c. Retained earnings of $8,000.
d. Paid-in capital from treasury stock of $12,000.

2M81#6. An analysis of the stockholders' equity of Barton Corporation as of January 1, 1980, is as follows:

- Common stock, par value $20; authorized 200,000 shares; issued and outstanding, 120,000 shares $2,400,000
- Additional paid-in capital 280,000
- Retained earnings 1,540,000
- Total $4,220,000

Barton uses the cost method of accounting for treasury stock and during 1980 recorded the following transactions:

- Acquired 2,000 shares of its stock for $70,000
- Sold 1,200 treasury shares at $40 per share
- Retired the remaining treasury shares

Assuming no other equity transactions occurred during 1980, what should Barton report at December 31, 1980, as additional paid-in capital?

| a. $274,000 |
| b. $280,000 |
| c. $304,000 |
| d. $316,000 |

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E. Stock Options, Warrants, and Rights

1N84#30. On March 2, 1983, Tooker Company purchased 2,000 shares of Apex Corporation's newly issued 6% cumulative $100 par value preferred stock for $217,000. Each preferred share carried one detachable stock warrant which entitled the holder to acquire, at $17, one share of Apex $10 par common stock. On March 3, 1983, the market price of the preferred stock (without warrants) was $90 per share and the market price of the stock warrants was $15 per warrant. On December 23, 1983, Tooker sold all the stock warrants for $35,200. The gain on the sale of the stock warrants was

   a. $0
   b. $1,200
   c. $4,200
   d. $5,200

1N82#17. On January 1, 1981, Stoner Corporation granted stock options to key employees for the purchase of 10,000 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, 1983, by grantees still in the employ of the company. The market price of Stoner's common stock was $32 per share at the date of grant. Stoner plans to distribute up to 10,000 shares of treasury stock when options are exercised. The treasury stock was acquired by Stoner during 1980 at a cost of $28 per share and was recorded under the cost method. Assume that no stock options were terminated during the year. How much should Stoner charge to compensation expense for the year ended December 31, 1981?

   a. $70,000
   b. $35,000
   c. $30,000
   d. $15,000

2M81

Items 10 and 11 are based on the following information:

On January 1, 1980, Karva Company granted James Dean, the president, an option to purchase 1,000 shares of Karva's $30 par value common stock at $40 per share. The option becomes exercisable on January 1, 1982, after Dean has completed two years of service.

10. Assume that the quoted market prices of Karva's $30 par value common stock were as follows:

   January 1, 1980 $40
   December 31, 1980 55

As a result of the option granted to Dean, Karva should recognize compensation expense in 1980 of

   a. $0
   b. $5,000
   c. $7,500
   d. $15,000

11. Assume that the quoted market prices of Karva's $30 par value common stock were as follows:

   - January 1, 1980 $45
   - December 31, 1980 55

As a result of the option granted to Dean, Karva should recognize compensation expense in 1980 of

   a. $0
   b. $2,500
   c. $5,000
   d. $7,500

2M81#12. On July 1, 1980, Metaro Corporation purchased for $108,000, 2,000 shares of Jean Corporation's newly issued 6% cumulative $20 par value preferred stock. Each share also had one stock warrant attached, which entitled the holder to acquire, at $19, one share of Jean $10 par value common stock for each two warrants held. On July 2, 1980, the market price of the preferred stock (without warrants) was $50 per share and the market price of the stock warrants was $10 per warrant. On September 1, 1980, Metaro sold all the stock warrants for $19,800.

   What should be the gain on the sale of the stock warrants?

   a. $0
   b. $800
   c. $1,800
   d. $9,800

F. Reorganization and Change in Entity

1M85#21. The December 31, 1984, condensed balance sheet of Dunn Services, an individual proprietorship, follows:

<table>
<thead>
<tr>
<th>Current assets</th>
<th>$140,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment (net)</td>
<td>130,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$70,000</td>
</tr>
<tr>
<td>John Dunn, Capital</td>
<td>200,000</td>
</tr>
<tr>
<td>Total</td>
<td>$270,000</td>
</tr>
</tbody>
</table>

Fair values at December 31, 1984, are as follows:

<table>
<thead>
<tr>
<th>Current assets</th>
<th>$160,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>210,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>70,000</td>
</tr>
</tbody>
</table>

On January 2, 1985, Dunn Services was incorporated, with 5,000 shares of $10 par value common stock issued.

   How much should be credited to additional paid-in capital?

   a. $320,000
   b. $250,000
   c. $230,000
   d. $200,000
1N84#31. Clark Corporation was organized to consolidate the resources of Allen Company and Bell Company in a business combination appropriately accounted for by the pooling of interests method. On January 1, 1984, Clark issued 62,000 shares of its $10 par value voting stock in exchange for all of the outstanding capital stock of Allen and Bell. The equity accounts of Allen and Bell on this data were:

<table>
<thead>
<tr>
<th>Allen</th>
<th>Bell</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, at par value</td>
<td>$200,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>25,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>120,000</td>
<td>210,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$345,000</strong></td>
<td><strong>$645,000</strong></td>
</tr>
</tbody>
</table>

What is the balance in Clark's additional paid-in capital account immediately after the business combination?

a. $0
b. $40,000
c. $60,000
d. $390,000

1N84#35. Decker Company filed a voluntary bankruptcy petition on August 15, 1984, and the statement of affairs reflects the following amounts:

<table>
<thead>
<tr>
<th>Book carrying amount</th>
<th>Estimated current value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Assets pledged with fully secured creditors</td>
<td>$150,000</td>
</tr>
<tr>
<td>Assets pledged with partially secured creditors</td>
<td>90,000</td>
</tr>
<tr>
<td>Free assets</td>
<td>210,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$450,000</strong></td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Liabilities with priority</td>
<td>$35,000</td>
</tr>
<tr>
<td>Fully secured creditors</td>
<td>130,000</td>
</tr>
<tr>
<td>Partially secured creditors</td>
<td>100,000</td>
</tr>
<tr>
<td>Unsecured creditors</td>
<td>270,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$535,000</strong></td>
</tr>
</tbody>
</table>

Assume that the assets are converted into cash at the estimated current values and the business is liquidated. What total amount of cash should the partially secured creditors receive?

a. $60,000
b. $84,000
c. $90,000
d. $100,000

2M83#12. Following is the condensed balance sheet of Fine Products, an individual proprietorship, at December 31, 1982:

| Current assets | $100,000 |
| Equipment | 200,000 |
| Accumulated depreciation | (120,000) |
| **Total** | **$180,000** |
| Liabilities | $40,000 |
| Silvia Fine, Capital | 140,000 |
| **Total** | **$180,000** |

Fair market values of assets at December 31, 1982, were as follows:

| Current assets | $110,000 |
| Equipment | 290,000 |

The liabilities were fairly stated at book values. On January 2, 1983, the proprietorship was incorporated, with 2,000 shares of $20 par value common stock issued. How much should be credited to additional paid-in capital?

a. $100,000
b. $140,000
c. $320,000
d. $360,000

1N83#48. Scott Company filed a voluntary bankruptcy petition on June 25, 1982, and the statement of affairs reflects the following amounts:
2N82
Items 3 and 4 are based on the following data:

On March 1, 1982, Agront Corporation issued 10,000 shares of its $1 par value common stock for all of the outstanding stock of Barcelo Corporation, when the fair market value of Agront's stock was $50 per share. In addition, Agront made the following payments in connection with this business combination:

<table>
<thead>
<tr>
<th>Description</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finder's and consultants' fees</td>
<td>$20,000</td>
</tr>
<tr>
<td>SEC registration costs</td>
<td>7,000</td>
</tr>
</tbody>
</table>

3. If this business combination is treated as a pooling of interests, how much should be recorded as business combination expenses in 1982?
   a. $0
   b. $7,000
   c. $20,000
   d. $27,000

4. If this business combination is treated as a purchase, Agront's acquisition cost would be capitalized at
   a. $0
   b. $500,000
   c. $520,000
   d. $527,000

1N81#13. On January 1, 1980, Platt Company issued 200,000 additional shares of $5 par value voting common stock in exchange for all of Drew Company's voting common stock in a business combination appropriately accounted for by the pooling of interests method. Immediately before the business combination, the total stockholders' equity of Platt was $16,000,000 and of Drew was $4,000,000. Net income for the year ended December 31, 1980, was $1,500,000 for Platt, exclusive of any consideration of Drew, and $450,000 for Drew. During 1980, Platt paid $750,000 in dividends to its stockholders. The consolidated stockholders' equity at December 31, 1980, should be
   a. $17,750,000
   b. $19,250,000
   c. $21,200,000
   d. $21,950,000

2N81
Items 36 and 37 are based on the following data:

On January 1, 1981, Rolan Corporation issued 10,000 shares of common stock in exchange for all of Sandin Corporation's outstanding stock. Condensed balance sheets of Rolan and Sandin immediately prior to the combination are as follows:

<table>
<thead>
<tr>
<th>Rolan</th>
<th>Sandin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$300,000</td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>200,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>500,000</td>
</tr>
<tr>
<td>Total equities</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Rolan's common stock had a market price of $60 per share on January 1, 1981. The market price of Sandin's stock was not readily ascertainable.

36. Assuming that the combination of Rolan and Sandin qualifies as a purchase, Rolan's investment in Sandin's stock will be stated in Rolan's balance sheet immediately after the combination in the amount of
   a. $100,000
   b. $350,000
   c. $500,000
   d. $600,000

37. Assuming that the combination of Rolan and Sandin qualifies as a pooling of interests, rather than as a purchase, what should be reported as retained earnings in the consolidated balance sheet immediately after the combination?
   a. $500,000
   b. $600,000
   c. $750,000
   d. $850,000

G. Partnerships

1N85#22. Cody and Paul formed a partnership on April 1, 1985, and contributed the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Cody</th>
<th>Paul</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$150,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Land</td>
<td>310,000</td>
<td></td>
</tr>
</tbody>
</table>

The land was subject to a mortgage of $30,000, which was assumed by the partnership. Under the partnership agreement, Cody and Paul will share profit and loss in the ratio of one-third and two-thirds, respectively. Paul's capital account at April 1, 1985, should be
   a. $300,000
   b. $330,000
   c. $340,000
   d. $360,000

1N85#26. At December 31, 1984, Arno and Dey are partners with capital balances of $80,000 and $40,000, and they share profit and loss in the ratio of 2:1, respectively. On this date West invests $36,000 cash for
Accounting Practice

a one-fifth interest in the capital and profit of the new partnership. The partners agree that the implied partnership goodwill is to be recorded simultaneously with the admission of West. The total implied goodwill of the firm is

a. $ 4,800
b. $ 6,000
c. $24,000
d. $30,000

1N84#18. The partnership agreement of Jones, King, and Lane provides for annual distribution of profit or loss in the following order:

• Jones, the managing partner, receives a bonus of 20% of profit.
• Each partner receives 15% interest on average capital investment.
• Residual profit or loss is divided equally.

The average capital investments for 1983 were:

<table>
<thead>
<tr>
<th></th>
<th>Jones</th>
<th></th>
<th>King</th>
<th></th>
<th>Lane</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>$100,000</td>
<td></td>
<td>$200,000</td>
<td></td>
<td>$300,000</td>
<td></td>
</tr>
</tbody>
</table>

How much of the $90,000 partnership profit for 1983 should be distributed to Jones?

a. $15,000
b. $27,000
c. $30,000
d. $33,000

1N84#34. Ames and Buell are partners who share profits and losses in the ratio of 3:2, respectively. On August 31, 1984, their capital accounts were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Ames</th>
<th></th>
<th>Buell</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>$70,000</td>
<td></td>
<td>$60,000</td>
<td></td>
</tr>
</tbody>
</table>

On that date they agreed to admit Carter as a partner with a one-third interest in the capital and profits and losses, for an investment of $50,000. The new partnership will begin with a total capital of $180,000. Immediately after Carter's admission, what are the capital balances of the partners?

<table>
<thead>
<tr>
<th></th>
<th>Ames</th>
<th></th>
<th>Buell</th>
<th></th>
<th>Carter</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>$60,000</td>
<td></td>
<td>$60,000</td>
<td></td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$63,333</td>
<td></td>
<td>$56,667</td>
<td></td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$64,000</td>
<td></td>
<td>$56,000</td>
<td></td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$70,000</td>
<td></td>
<td>$60,000</td>
<td></td>
<td>$50,000</td>
<td></td>
</tr>
</tbody>
</table>

2M83#11. Luca and Mira formed a partnership on July 1, 1982, and contributed the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Luca</th>
<th></th>
<th>Mira</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>$65,000</td>
<td></td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Value</td>
<td>300,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The realty was subject to a mortgage of $25,000, which was assumed by the partnership. The partnership agreement provides that Luca and Mira will share profits and losses in the ratio of one-third and two-thirds, respectively. Mira's capital account at July 1, 1982, should be

a. $400,000
b. $391,667
c. $375,000
d. $310,000
Selected Questions

2N81#25. On June 30, 1981, the balance sheet for the partnership of Coll, Maduro, and Prieto, together with their respective profit and loss ratios, were as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets, at cost</td>
<td>$180,000</td>
</tr>
<tr>
<td>Coll, loan</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>Coll, capital (20%)</td>
<td>42,000</td>
</tr>
<tr>
<td>Maduro, capital (20%)</td>
<td>39,000</td>
</tr>
<tr>
<td>Prieto, capital (60%)</td>
<td>90,000</td>
</tr>
<tr>
<td>Total</td>
<td>$180,000</td>
</tr>
</tbody>
</table>

Coll has decided to retire from the partnership. By mutual agreement, the assets are to be adjusted to their fair value of $216,000 at June 30, 1981. It was agreed that the partnership would pay Coll $61,200 cash for Coll’s partnership interest, including Coll’s loan which is to be repaid in full. No goodwill is to be recorded. After Coll’s retirement, what is the balance of Maduro’s capital account?

a. $36,450
b. $39,000
c. $45,450
d. $46,200

2N81#26. The following condensed balance sheet is presented for the partnership of Alexander, Bell and Graham, who share profits and losses in the ratio of 6:2:2, respectively:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>280,000</td>
</tr>
<tr>
<td>Total</td>
<td>$360,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$140,000</td>
</tr>
<tr>
<td>Alexander, capital</td>
<td>100,000</td>
</tr>
<tr>
<td>Bell, capital</td>
<td>100,000</td>
</tr>
<tr>
<td>Graham, capital</td>
<td>20,000</td>
</tr>
<tr>
<td>Total</td>
<td>$360,000</td>
</tr>
</tbody>
</table>

The partners agreed to liquidate the partnership after selling the other assets. If the other assets are sold for $160,000, how much should Alexander receive upon liquidation?

a. $25,000
b. $26,000
c. $28,000
d. $100,000

2N81#27. On July 1, 1981, Motta and Puleo formed a partnership, agreeing to share profits and losses in the ratio of 4:6, respectively. Motta contributed a parcel of land that cost him $25,000. Puleo contributed $50,000 cash. The land was sold for $50,000 on July 1, 1981, four hours after formation of the partnership. How much should be recorded in Motta’s capital account on formation of the partnership?

a. $10,000
b. $20,000
c. $25,000
d. $50,000

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

1M85#23. Hansen Construction, Inc., has consistently used the percentage-of-completion method of recognizing income. During 1984 Hansen started work on a $3,000,000 fixed-price construction contract. The accounting records disclosed the following data for the year ended December 31, 1984:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs incurred</td>
<td>$ 930,000</td>
</tr>
<tr>
<td>Estimated cost to complete</td>
<td>2,170,000</td>
</tr>
<tr>
<td>Progress billings</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Collections</td>
<td>700,000</td>
</tr>
</tbody>
</table>

How much loss should Hansen have recognized in 1984?

a. $230,000
b. $100,000
c. $30,000
d. $0

1M85#27. A foreign subsidiary of Decker Corporation has certain balance sheet accounts at December 31, 1984. Information relating to these accounts in U.S. dollars is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Current rate</th>
<th>Historical rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketable securities, at cost</td>
<td>$ 65,000</td>
<td>$ 75,000</td>
</tr>
<tr>
<td>Inventories, at average cost</td>
<td>500,000</td>
<td>550,000</td>
</tr>
<tr>
<td>Patents</td>
<td>80,000</td>
<td>85,000</td>
</tr>
<tr>
<td></td>
<td>$645,000</td>
<td>$710,000</td>
</tr>
</tbody>
</table>

What total amount should be included in Decker’s December 31, 1984, consolidated balance sheet for the above accounts?

a. $710,000
b. $700,000
c. $660,000
d. $645,000
1M85#29. Ott Company began operations on January 1, 1983, and appropriately uses the installment sales method of accounting. The following data are available for 1983 and 1984:

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Installment sales</td>
<td>$1,500,000</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>30%</td>
<td>40%</td>
</tr>
<tr>
<td>Cash collections from:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1983 sales</td>
<td>500,000</td>
<td>600,000</td>
</tr>
<tr>
<td>1984 sales</td>
<td>—</td>
<td>700,000</td>
</tr>
</tbody>
</table>

The realized gross profit for 1984 is
a. $720,000
b. $520,000
c. $460,000
d. $280,000

1M85#30. On January 1, 1984, Jasen, Inc., issued 200,000 additional shares of $10 par value voting common stock in exchange for all of Wall Company’s voting common stock in a business combination appropriately accounted for by the pooling of interests method. Net income for the year ended December 31, 1984, was $800,000 for Wall and $2,600,000 for Jasen, exclusive of any consideration of Wall. During 1984 Jasen paid $1,800,000 in dividends to its stockholders and Wall paid $500,000 in dividends to Jasen. What should be the consolidated net income for the year ended December 31, 1984?

a. $2,300,000
b. $2,900,000
c. $3,100,000
d. $3,400,000

1M85#31. On July, 1984, Dixon Company purchased Mill Corporation ten-year, 12% bonds with a face value of $300,000 for $324,000, which included $12,000 of accrued interest. The bonds, which mature on March 1, 1991, pay interest semiannually on March 1 and September 1. Dixon appropriately uses the straight-line method of amortization. The amount of income Dixon should report for the calendar year 1984 as a result of this long-term investment is

a. $16,200
b. $17,100
c. $18,000
d. $30,000

1M85#32. On January 2, 1984, Kiner Company sold the copyright to a book to Western Publishers, Inc., for royalties of 20% of future sales. The same date Western paid Kiner a royalty advance of $50,000 to be applied against royalties for 1983 sales. On September 30, 1984, Western made a $21,000 royalty remittance to Kiner for sales in the six-month period ended June 30, 1984. In January 1985, before issuance of its 1984 financial statements, Kiner learned that Western’s sales of the book totaled $125,000 for the last half of 1984. How much royalty income should Kiner report in its 1984 income statement?

1. $21,000
2. $46,000
3. $71,000
4. $75,000

1M85#33. On January 1, 1984, Bishop Company, a lessee of office machines, purchased for $650,000 a new machine, which is expected to have a ten-year life, and will be depreciated $65,000 per year. The same day the machine was leased to Hall for a four-year period expiring January 1, 1988, at an annual rental of $150,000. Hall also paid a nonrefundable lease fee of $50,000 to Bishop on January 1, 1984. During 1984 Bishop incurred insurance and other related costs of $18,000 under the lease. For the year ended December 31, 1984, what amount should Bishop report as operating profit on this leased asset?

a. $67,000
b. $79,500
c. $85,000
d. $117,000

1M85#34. Cox Company received dividends from its common stock investments during the year ended December 31, 1984, as follows:

- A cash dividend of $5,000 from West Corporation, in which Cox owns a 2% interest.
- A cash dividend of $50,000 from Bell Corporation, in which Cox owns a 30% interest. A majority of Cox’s directors are also directors of Bell.
- A stock dividend of 300 shares from Mill Corporation was received on December 10, 1984, on which date the quoted market value of Mill’s shares was $10 per share. Cox owns less than 1% of Mill’s common stock.

How much dividend income should Cox report in its 1984 income statement?

1. $5,000
2. $8,000
3. $55,000
4. $58,000

1M85#39. The validity of a patent held by Gordon Company was disputed by Ashley in a lawsuit filed against Gordon in 1983. At December 31, 1983, Gordon’s counsel and management determined that it was probable that Ashley would be successful against Gordon for an estimated amount of $350,000. Accordingly, a loss of $350,000 was accrued by a charge to income for the year ended December 31, 1983. On December 31, 1984, Gordon and Ashley agreed to a settlement providing for: (1) assignment of Gordon’s patent to Ashley, and (2) payment of $200,000 by Gordon to Ashley. The carrying value of the patent on Gordon’s
books was $90,000 at December 31, 1984. What would be the effect of the settlement of Ashley's lawsuit on Gordon's income before income tax in 1984?
a. No effect.
b. $60,000 increase.
c. $150,000 increase.
d. $290,000 decrease.

1N84#30. Kew Company leased equipment to Pitt on January 1, 1984, for an eight-year period expiring December 31, 1991. Equal payments under the lease of $300,000 are due on January 1 of each year. The first payment was made on January 1, 1984. The rate of interest contemplated by Kew and Pitt is 10%. The cash selling price of the equipment is $1,760,000 and the cost of the equipment on Kew's accounting records is $1,400,000. Kew appropriately recorded the lease as a sales-type lease. For the year ended December 31, 1984, what amount of profit on the sale and interest income should Kew record?
a. $0 and $0.
b. $0 and $80,000.
c. $360,000 and $146,000.
d. $360,000 and $176,000.

1N84#38. Frey Company bought a building at auction on June 30, 1983, for $2,000,000. On July 15, 1983, before occupying the building, Frey sold it to a creditworthy company for $2,400,000. Frey received a cash down payment of $600,000 and a first mortgage note at the market rate of interest, for the balance. No additional payments were required by the buyer until July 1984. How much gain should Frey recognize on July 15, 1983, from the sale of the building?
a. $0
b. $100,000
c. $400,000
d. $600,000

1N84#39. Landy Construction Company has consistently used the percentage-of-completion method of recognizing income. During 1981 Landy started work on a $7,500,000 fixed-price construction contract, which was completed in 1984. The accounting records disclosed the following data:

<table>
<thead>
<tr>
<th>Cumulative contract costs</th>
<th>Estimated costs at completion</th>
</tr>
</thead>
<tbody>
<tr>
<td>At 12/31/81</td>
<td>$ 500,000</td>
</tr>
<tr>
<td>At 12/31/82</td>
<td>2,750,000</td>
</tr>
<tr>
<td>At 12/31/83</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>

How much income should Landy have recognized on this contract for the year ended December 31, 1983?

1N84#40. On July 1, 1983, Barker Company purchased 20% of the outstanding common stock of Acme Company for $400,000 when the fair value of Acme's net assets was $2,000,000. Barker does not have the ability to exercise significant influence over the operating and financial policies of Acme. The following data concerning Acme are available for 1983:

<table>
<thead>
<tr>
<th>12 months ended 12/31/83</th>
<th>6 months ended 12/31/83</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$300,000</td>
</tr>
<tr>
<td>Dividends declared and paid</td>
<td>190,000</td>
</tr>
</tbody>
</table>

In its income statement for the year ended December 31, 1983, how much income should Barker report from this investment?

1N84#41. On January 1, 1984, Grafton Company sold a machine to Sussex Company, and simultaneously leased it back for one year. Pertinent data are as follows:

| Sales price | $240,000 |
| Carrying value at 12/31/83 | $210,000 |
| Estimated remaining useful life at 12/31/83 | 12 years |
| Monthly rental under leaseback | $2,000 |
| Interest rate implicit in lease | 12% |
| Present value of lease rentals at 1/1/84 | $22,736 |

How much profit should Grafton recognize on January 1, 1984, on the sale of the machine?

1N84#42. On January 1, 1983, Riley Company sold a building which cost $380,000 and had accumulated depreciation of $160,000 on the date of sale. Riley received as consideration a $400,000 noninterest bearing note due on January 1, 1986. 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, 1983, was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest income should be included in Riley's 1983 income statement?

1N84#43. Dalton Company owns 1,000 shares of Reber, Inc., $10 par value common stock which was acquired on July 1, 1983, at a cost of $19,000. On April
30, 1984, Reber issued a 10% common stock dividend when the market price of its common stock was $24 per share. As a result of this stock dividend, Dalton should record dividend income of
a. $2,400
b. $1,900
c. $1,000
d. $0

1M84#47. Grady Company purchased a machine on January 1, 1983, for $720,000. The machine is expected to have a ten-year life, no residual value, and will be depreciated by the straight-line method. On January 1, 1983, the machine was leased to Lesch Company for a three-year period, at an annual rental of $125,000. Grady could have sold the machine for $860,000 instead of leasing it. Grady incurred maintenance and other executory costs of $15,000 in 1983 under the terms of the lease. What amount should Grady report as operating profit on this leased asset for the year ended December 31, 1983?
   a. $38,000
   b. $53,000
   c. $125,000
   d. $178,000

1M84#48. Walker, Inc., a U.S. corporation, ordered a machine from Pfla Company of West Germany on July 15, 1983, for 100,000 marks when the spot rate for marks was $.4955. Pfla shipped the machine on September 1, 1983, and billed Walker for 100,000 marks. The spot rate was $.4875 on this date. Walker bought 100,000 marks and paid the invoice on October 25, 1983, when the spot rate was $.4855. In Walker's income statement for the year ended December 31, 1983, how much should be reported as foreign exchange gain?
   a. $0
   b. $200
   c. $800
   d. $1,000

1M84#22. Hadley Construction Company has consistently used the percentage-of-completion method of recognizing income. During 1982 Hadley started work on a $3,000,000 construction contract which was completed in 1983. The accounting records provided the following data:

<table>
<thead>
<tr>
<th></th>
<th>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Progress billings</td>
<td>$1,100,000</td>
<td>$1,900,000</td>
</tr>
<tr>
<td>Costs incurred</td>
<td>900,000</td>
<td>2,800,000</td>
</tr>
<tr>
<td>Collections</td>
<td>700,000</td>
<td>2,300,000</td>
</tr>
<tr>
<td>Estimated cost to complete</td>
<td>1,800,000</td>
<td>—</td>
</tr>
</tbody>
</table>

How much income should Hadley have recognized in 1982?
   a. $100,000
   b. $110,000
   c. $150,000
   d. $200,000

1M84#27. Hiller Company manufactures equipment which is sold or leased. On December 31, 1983, Hiller leased equipment to Drake Company for a five-year period expiring December 31, 1988, at which date ownership of the leased asset is transferred to Drake. Equal payments under the lease are $20,000 and are due on December 31 of each year. The first payment was made on December 31, 1983. Collectibility of the remaining lease payments is reasonably assured and Hiller has no material cost uncertainties. The normal sales price of the equipment is $77,000 and Hiller's cost is $60,000. For the year ended December 31, 1983, how much income should Hiller recognize from the lease transaction?
   a. $0
   b. $17,000
   c. $20,000
   d. $23,000

1M84#28. On January 1, 1982, Bartell Company sold its idle plant facility to Cooper, Inc., for $1,050,000. On this date the plant had a depreciated cost of $735,000. Cooper paid $150,000 cash on January 1, 1982, and signed a $900,000 note bearing interest at 10%. The note was payable in three annual installments of $300,000 beginning January 1, 1983. Bartell appropriately accounted for the sale under the installment method. Cooper made a timely payment of the first installment on January 1, 1983, of $390,000, which included interest of $90,000 to date of payment. At December 31, 1983, Bartell has deferred gross profit of
   a. $153,000
   b. $180,000
   c. $225,000
   d. $270,000

1M84#29. On November 1, 1983, Allen Corporation issued shares of its voting common stock in exchange for all of the voting common stock of Bell, Inc., in a business combination appropriately accounted for by the pooling of interests method. The separate net income for each company was as follows:

<table>
<thead>
<tr>
<th></th>
<th>Allen</th>
<th>Bell</th>
</tr>
</thead>
<tbody>
<tr>
<td>12 months ended</td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 31, 1983</td>
<td>$1,000,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>2 months ended</td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 31, 1983</td>
<td>110,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

During September Bell paid $300,000 in dividends to its stockholders. For the year ended December 31, 1983, the consolidated net income should be
   a. $210,000
   b. $110,000
   c. $1,300,000
   d. $1,600,000

1M84#31. On January 4, 1982, Wynn, Inc., bought 15% of Parr Corporation's common stock for $60,000. Wynn appropriately accounts for this investment by the
Selected Questions

cost method. The following data concerning Parr are available for the years ended December 31, 1982 and 1983:

<table>
<thead>
<tr>
<th></th>
<th>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$30,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>None</td>
<td>80,000</td>
</tr>
</tbody>
</table>

In its income statement for the year ended December 31, 1983, how much should Wynn report as income from this investment?

a. $ 4,500  
b. $ 9,000  
c. $12,000  
d. $13,500

1M84#32. Decker 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 Decker's December 31 balance sheets:

<table>
<thead>
<tr>
<th></th>
<th>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalties receivable</td>
<td>$90,000</td>
<td>$85,000</td>
</tr>
<tr>
<td>Unearned royalties</td>
<td>60,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

During 1983 Decker received royalty remittances of $200,000. In its income statement for the year ended December 31, 1983, Decker should report royalty income of

a. $195,000  
b. $215,000  
c. $220,000  
d. $225,000

1M84#33. Wagner Company, a lessor of office machines, purchased a new machine for $500,000 on January 1, 1983, which was leased the same day to Lee Company. The machine is expected to have a ten-year life, and will be depreciated $50,000 per year. The lease is for a three-year period expiring January 1, 1986, and provides for annual rental payments of $100,000 beginning January 1, 1983. Additionally, Lee paid $60,000 as a lease bonus to obtain a three-year lease. In its 1983 income statement, what amount should Wagner report as operating profit on this leased asset?

a. $ 50,000  
b. $ 70,000  
c. $100,000  
d. $110,000

1M84#34. On January 3, 1983, Paterson Services, Inc., signed an agreement authorizing Cobb Company to operate as a franchisee over a 20-year period for an initial franchise fee of $50,000 received when the agreement was signed. Cobb commenced operations on July 1, 1983, at which date all of the initial services required of Paterson had been performed. The agreement also provides that Cobb must pay a continuing franchise fee equal to 5% of the revenue from the franchise annually to Paterson. Cobb’s franchise revenue for 1983 was $400,000. For the year ended December 31, 1983, how much should Paterson record as revenue from franchise fees in respect of the Cobb franchise?

a. $70,000  
b. $50,000  
c. $45,000  
d. $22,500

1N83#26. On July 1, 1982, Diamond, Inc., paid $1,000,000 for 100,000 shares (40%) of the outstanding common stock of Ashley Corporation. At that date the net assets of Ashley totaled $2,500,000 and the fair values of all of Ashley's identifiable assets and liabilities were equal to their book values. Ashley reported net income of $500,000 for the year ended December 31, 1982, of which $300,000 was for the six months ended December 31, 1982. Ashley paid cash dividends of $250,000 on September 30, 1982. In its income statement for the year ended December 31, 1982, what amount of income should Diamond report from its investment in Ashley?

a. $ 80,000  
b. $100,000  
c. $120,000  
d. $200,000

1N83#32. On December 27, 1982, Holden Company sold a building, receiving as consideration a $400,000 noninterest bearing note due in three years. The building cost $380,000 and the accumulated depreciation was $160,000 at the date of sale. The prevailing rate of interest for a note of this type was 12%. The present value of $1 for three periods at 12% is 0.71. In its 1982 income statement, how much gain or loss should Holden report on the sale?

a. $ 20,000 gain  
b. $ 64,000 gain  
c. $ 96,000 loss  
d. $180,000 gain

1N83#37. On January 1, 1982, Kiner Company formed a foreign branch. The branch purchased merchandise at a cost of 720,000 local currency units (LCU) on February 15, 1982. The purchase price was equivalent to $180,000 on this date. The branch's inventory at December 31, 1982, consisted solely of merchandise purchased on February 15, 1982, and amounted to 240,000 LCU. The exchange rate was 6 LCU to $1 on December 31, 1982, and the average rate of exchange was 5 LCU to $1 for 1982. Assume that the LCU is the functional currency of the branch. In Kiner's December 31, 1982, balance sheet, the branch inventory balance of 240,000 LCU should be translated into United States dollars at

a. $40,000  
b. $48,000  
c. $60,000  
d. $84,000

AP-47
2M83#2. Adams Construction Co. uses the percentage-of-completion method of accounting. During 1982, Adams contracted to build an apartment house for Roper for $10,000,000. Adams estimated that total costs would amount to $8,000,000 over the period of construction. In connection with this contract, Adams incurred $1,000,000 of construction costs during 1982. Adams billed and collected $1,500,000 from Roper in 1982. How much gross profit should Adams recognize in 1982?

a. $300,000
b. $250,000
c. $187,500
d. $125,000

2M83

Items 21 and 22 are based on the following information:

On January 2, 1982, Doe Company leased a new crane from Leasement Corp. under the following terms:

- Noncancellable for eight years
- Annual lease payments of $10,000 beginning January 2, 1982, through January 2, 1989
- Nonrenewable
- Crane to be returned to Leasement on January 2, 1990

Doe properly recorded the crane as a "Leased asset — crane" in the amount of $52,880, based on a 14% interest rate implicit in the lease. Leasement paid $56,000 for the crane on December 31, 1981. The crane has an estimated useful life of ten years, with no salvage value. Both Doe and Leasement use the straight-line method of depreciation.

22. How much interest income should Leasement recognize in 1982?

a. $10,000
b. $ 7,403
c. $ 6,003
d. $0

2M83

Items 38 through 40 are based on the following information:

The general ledger of Rosson Corporation showed the following investments at January 1, 1982:

<table>
<thead>
<tr>
<th>Common stock:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Joyce Corp. (2,000 shares)</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>James Corp. (8,000 shares)</td>
<td>400,000</td>
</tr>
<tr>
<td>Real estate:</td>
<td></td>
</tr>
<tr>
<td>Vacant lot #4 (leased to Whit Corp.)</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Other:</td>
<td></td>
</tr>
<tr>
<td>Textbook, Ancient Accounting</td>
<td></td>
</tr>
<tr>
<td>(original preparation and printing costs)</td>
<td>80,000</td>
</tr>
</tbody>
</table>

Total investments $1,580,000

Rosson owns 2% of Joyce and 30% of James. A majority of Rosson's directors are also directors of James. The Whit lease is for ten years, starting December 31, 1980, at an annual rental of $60,000. In addition, Whit paid a nonrefundable rental deposit of $100,000 on December 31, 1980, as well as a security deposit of $50,000 to be refunded upon expiration of the lease. Ancient Accounting, a textbook written by Rosson's personnel in 1979, was sold to Endless Hall, Inc., for royalties of 20% of sales. Royalties are payable semiannually on April 30 (for sales in July through December of the previous year) and on October 31 (for sales in January through June of the same year).
During the year ended December 31, 1982, Rosson received cash dividends of $2,000 from Joyce and $24,000 from James, whose 1982 net incomes were $80,000 and $200,000, respectively. Rosson also received $60,000 of rent from Whit in 1982, and the following royalty checks from Endless:

<table>
<thead>
<tr>
<th></th>
<th>April 30</th>
<th>October 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>$12,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>1982</td>
<td>10,000</td>
<td>13,000</td>
</tr>
</tbody>
</table>

Endless estimated that sales of *Ancient Accounting* would total $70,000 for the last half of 1982.

38. How much dividend income should Rosson report in its 1982 income statement?
   a. $0
   b. $2,000
   c. $26,000
   d. $61,600

39. How much rental revenue should Rosson report in its 1982 income statement?
   a. $0
   b. $60,000
   c. $70,000
   d. $75,000

40. How much royalty revenue should Rosson report in its 1982 income statement?
   a. $23,000
   b. $25,000
   c. $26,000
   d. $27,000

1M82#14. On April 1, 1980, Pine Construction Company entered into a fixed-price contract to construct an apartment building for $6,000,000. Pine appropriately accounts for this contract under the percentage-of-completion method. Information relating to the contract is as follows:

<table>
<thead>
<tr>
<th>Percentage of completion</th>
<th>At December 31, 1980</th>
<th>At December 31, 1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated costs at completion</td>
<td>$4,500,000</td>
<td>$4,800,000</td>
</tr>
<tr>
<td>Income recognized (cumulative)</td>
<td>$300,000</td>
<td>$720,000</td>
</tr>
</tbody>
</table>

What is the amount of contract costs incurred during the year ended December 31, 1981?
   a. $1,200,000
   b. $1,920,000
   c. $1,980,000
   d. $2,880,000

2M82#13. Tollner Company sold a machine to Snead Corporation on January 1, 1980, for which the cash sales price was $379,100. Snead entered into an installment sales contract with Tollner, calling for annual payments of $100,000 for five years, including interest at 10%. The first payment was due on December 31, 1980. How much interest income should be recorded by Tollner in 1981?
   a. $27,910
   b. $31,701
   c. $37,910
   d. $50,000

1M82#19. Melville Company leased equipment from Rice Corporation on July 1, 1981, for an eight-year period expiring June 30, 1989. 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, 1981. The rate of interest contemplated by Melville and Rice is 10%. The cash selling price of the equipment is $3,520,000 and the cost of the equipment on Rice's accounting records is $2,800,000. Assuming that the lease is appropriately recorded as a sales-type lease, what is the amount of profit on the sale and interest income that Rice should record for the year ended December 31, 1981?
   a. $0 and $0.
   b. $0 and $146,000.
   c. $720,000 and $146,000.
   d. $720,000 and $160,000.

2M82#1. On November 30, 1980, Tyrola Publishing Company, located in Colorado, executed a contract with Ernest Blyton, an author from Canada, providing for payment of 10% royalties on Canadian sales of Blyton's book. Payment is to be made in Canadian dollars each January 10 for the previous year's sales. Canadian sales of the book for the year ended December 31, 1981, totaled $50,000 Canadian. Tyrola paid Blyton his 1981 royalties on January 10, 1982. Tyrola's 1981 financial statements were issued on February 1, 1982. Spot rates for Canadian dollars were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 30, 1980</td>
<td>$.87</td>
</tr>
<tr>
<td>January 1, 1981</td>
<td>$.88</td>
</tr>
<tr>
<td>December 31, 1981</td>
<td>$.89</td>
</tr>
<tr>
<td>January 10, 1982</td>
<td>$.90</td>
</tr>
</tbody>
</table>

How much should Tyrola accrue for royalties payable at December 31, 1981?
   a. $4,350
   b. $4,425
   c. $4,450
   d. $4,500

2M82#6. Bicar Corporation owns 10% of the outstanding capital stock of Kopel, Inc. On December 31, 1981, when Kopel's retained earnings was $50,000, Bi-
car received a plot of land from Kopel in a nonreciprocal transfer. Kopel's cost of the land was $7,000 and its fair market value at December 31, 1981, was $15,000. At what amount should this land be recorded on Bicar's books?

- a. $0
- b. $ 5,000
- c. $ 7,000
- d. $15,000

**2N82#7.** Dale, Inc., a U.S. corporation, bought machine parts from Kluger Company of West Germany on March 1, 1981, for 30,000 marks, when the spot rate for marks was $.4895. Dale's year-end was March 31, 1981, when the spot rate for marks was $.4845. Dale bought 30,000 marks and paid the invoice on April 20, 1981, when the spot rate was $.4945. How much should be shown in Dale's income statements as foreign exchange gain or loss for the years ended March 31, 1981 and 1982?

<table>
<thead>
<tr>
<th></th>
<th>1981</th>
<th>1982</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>b.</td>
<td>$0</td>
<td>$150 loss</td>
</tr>
<tr>
<td>c.</td>
<td>$150 loss</td>
<td>$0</td>
</tr>
<tr>
<td>d.</td>
<td>$150 gain</td>
<td>$300 loss</td>
</tr>
</tbody>
</table>

**2N82#11.** On December 31, 1981, Paulison Corporation signed an operating lease for a warehouse with Outwater Company for ten years, at $12,000 per year. Upon execution of the lease, Outwater paid Paulison $24,000, covering rent for the first two years. Paulison closed its books on December 31, and correctly reported $24,000 as gross rental income on its 1981 federal income tax return. How much should be shown in Paulison's 1981 income statement as gross rental income?

- a. $0
- b. $ 1,000
- c. $12,000
- d. $24,000

**2N81#33.** On January 1, 1980, Cardow Corporation sold a machine to Simpson Corporation, and simultaneously leased it back for three years. Pertinent data are:

- Estimated remaining useful life at December 31, 1979: 10 years
- Sales price: $120,000
- Carrying value at December 31, 1979: $20,000
- Monthly rental under leaseback: $1,266
- Interest rate implicit in lease: 12%
- Present value of lease rentals: ($1,266 for 36 months @ 12%) = $38,116

How much profit should Cardow recognize on January 1, 1980, on the sale of the machine?

- a. $0
- b. $33,333
- c. $61,884
- d. $100,000

**2N81#40.** Bucca Warehousing Corporation bought a building at auction on June 30, 1980, for $1,000,000. On July 2, 1980, before occupying the building, Bucca sold it to a triple-A rated company for $1,200,000. Bucca received a cash down payment of $300,000 and a first mortgage note at the market rate of interest, for the balance. No additional payments were required until 1981. On September 1, 1980, an independent appraiser valued the property at $1,500,000. On its 1980 income tax return, Bucca reported the sale on the installment basis. How much gain should Bucca recognize in its income statement for the year ended December 31, 1980?

- a. $0
- b. $50,000
- c. $200,000
- d. $300,000

**1M81#5.** Mercer Construction Company recognizes income under the percentage-of-completion method of reporting income from long-term construction contracts. During 1978 Mercer entered into a fixed-price contract to construct a bridge for $15,000,000. Contract costs incurred and estimated costs to complete the bridge were as follows:

<table>
<thead>
<tr>
<th>Cumulative contract costs incurred</th>
<th>Estimated costs to complete</th>
</tr>
</thead>
<tbody>
<tr>
<td>At December 31, 1978</td>
<td>$ 1,000,000</td>
</tr>
<tr>
<td>At December 31, 1979</td>
<td>5,500,000</td>
</tr>
<tr>
<td>At December 31, 1980</td>
<td>10,000,000</td>
</tr>
</tbody>
</table>

How much income should Mercer recognize on the above contract for the year ended December 31, 1980?

- a. $500,000
- b. $833,333
- c. $1,350,000
- d. $2,500,000
2M81#38. Howard Company sublet a portion of its warehouse for five years at an annual rental of $18,000, beginning on May 1, 1980. The tenant paid one year's rent in advance, which Howard recorded as a credit to unearned rental income. Howard reports on a calendar-year basis. The adjustment on December 31, 1980, should be

\[
\begin{array}{c|c|c}
\text{Dr.} & \text{Cr.} \\
\hline
\text{a. No entry} & \text{b. Unearned rental income} & $6,000 \\
& \text{Rental income} & $6,000 \\
\text{c. Rental income} & \text{Unearned rental income} & $6,000 \\
& \text{Rental income} & $12,000 \\
\text{d. Unearned rental income} & \text{Rental income} & $12,000 \\
\end{array}
\]

B. Expenses and Losses

1M85#35. The following expenses were recognized by Rex Company, a retailer, during 1984:

- Accounting and legal fees $240,000
- Loss on sale of long-term investment 110,000
- Property taxes and insurance 150,000
- Interest 90,000

How much of these expenses should be included in Rex's general and administrative expenses for 1984?

- a. $390,000
- b. $440,000
- c. $480,000
- d. $500,000

1M85#36. The following information is available for Day Company for 1984:

- Disbursements for purchases of merchandise $290,000
- Increase in trade accounts payable 25,000
- Decrease in merchandise inventory 10,000

How much is the cost of goods sold for 1984?

- a. $255,000
- b. $275,000
- c. $305,000
- d. $325,000

1M85#37. Heller Company's advertising expense account had a balance of $585,000 at December 31, 1984, before any necessary year-end adjustment relating to the following:

- Included in the $585,000 is the $60,000 cost of printing sales catalogs for a sales promotional campaign in January 1985.
- Television advertising spots telecast during December 1984 were billed to Heller on January 2, 1985. The invoice cost of $35,000 was paid on January 11, 1985.

The adjusted balance for advertising expense for the year ended December 31, 1984, should be

- a. $490,000
- b. $525,000
- c. $560,000
- d. $620,000

1M85#38. On January 1, 1984, Parke Company borrowed $360,000 from a major customer evidenced by a noninterest bearing note due in three years. Parke agreed to supply the customer's inventory needs for the loan period at lower than market price. At the 12% imputed interest rate for this type of loan, the present value of the note is $255,000 at January 1, 1984. What amount of interest expense should be included in Parke's 1984 income statement?

- a. $43,200
- b. $35,000
- c. $30,600
- d. $0

1M85#40. During 1984 Yost, Inc., incurred the following costs:

- Research and development services performed by Dell Company for Yost $250,000
- Testing for evaluation of new products 300,000
- Laboratory research aimed at discovery of new knowledge 375,000

In its income statement for the year ended December 31, 1984, Yost should report research and development expense of

- a. $250,000
- b. $300,000
- c. $625,000
- d. $925,000

1M85#41. A wholly owned subsidiary of Ward, Inc., has certain expense accounts for the year ended December 31, 1984, stated in local currency units (LCU) as follows:

\[
\begin{array}{c|c|c|c|c}
\text{Depreciation of equipment} & \text{Provision for doubtful accounts} & \text{Rent} \\
\hline
\text{LCU} & \text{LCU} & \text{LCU} \\
\hline
\text{120,000} & \text{80,000} & \text{200,000} \\
\end{array}
\]

The exchange rates at various dates are as follows:

<table>
<thead>
<tr>
<th>Dollar equivalent of 1 LCU</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1984</td>
</tr>
<tr>
<td>Average for year ended 12/31/84</td>
</tr>
<tr>
<td>January 1, 1982</td>
</tr>
</tbody>
</table>

Assume that the LCU is the subsidiary's functional currency and that the charges to the expense accounts occurred approximately evenly during the year. What
Accounting Practice

total dollar amount should be included in Ward’s 1984 consolidated income statement to reflect these expenses?

a. $160,000
b. $168,000
c. $176,000
d. $183,200

1M85#42. Stone Company’s allowance for doubtful accounts had a credit balance of $8,000 at December 31, 1983. Stone accrues bad debt expense monthly at 4% of credit sales. During 1984: (1) Stone’s credit sales amounted to $1,300,000, and (2) uncollectible accounts totaling $32,000 were written off. The aging of accounts receivable indicated that a $40,000 allowance for doubtful accounts was required at December 31, 1984. Stone’s bad debt expense for 1984 would be

a. $64,000
b. $52,000
c. $40,000
d. $32,000

1M85#43. Cooke Company acquires patent rights from other enterprises and pays advance royalties in some cases, and in others, royalties are paid within 90 days after year end. The following data are included in Cooke’s December 31 balance sheets:

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid royalties</td>
<td>$55,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Royalties payable</td>
<td>80,000</td>
<td>75,000</td>
</tr>
</tbody>
</table>

During 1984 Cooke remitted royalties of $300,000. In its income statement for the year ended December 31, 1984, Cooke should report royalty expense of

a. $295,000
b. $305,000
c. $310,000
d. $330,000

1M85#44. On December 31, 1984, Hurd Company signed an operating lease for a warehouse for ten years at $24,000 per year. Upon execution of the lease, Hurd paid $48,000 covering rent for the first two years. How much should be shown in Hurd’s income statement for the year ended December 31, 1984, as rent expense?

a. $0
b. $2,000
c. $24,000
d. $48,000

1M85#45. On January 1, 1983, for past services, Diven Company granted Mary Allen, its president, 5,000 stock appreciation rights which are exercisable immediately and expire three years after date of grant. On exercise, Allen is entitled to receive cash for the excess of the market value of the stock on the exercise date over the market value on the grant date. Allen exercised all of the rights on December 31, 1984. The per share market prices of Diven’s stock were as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 1983</td>
<td>$25</td>
</tr>
<tr>
<td>December 31, 1983</td>
<td>30</td>
</tr>
<tr>
<td>December 31, 1984</td>
<td>40</td>
</tr>
</tbody>
</table>

As a result of the stock rights, Diven should recognize compensation expense in 1984 of

a. $0
b. $50,000
c. $75,000
d. $200,000

1NB4

Items 44 and 45 are based on the following information:

Parker Corporation reports operating expenses in two categories: (1) selling and (2) general and administrative. The adjusted trial balance at December 31, 1983, included the following expense accounts:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting and legal fees</td>
<td>$175,000</td>
</tr>
<tr>
<td>Advertising</td>
<td>150,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>75,000</td>
</tr>
<tr>
<td>Interest</td>
<td>60,000</td>
</tr>
<tr>
<td>Loss on sale of long-term investment</td>
<td>30,000</td>
</tr>
<tr>
<td>Officers’ salaries</td>
<td>225,000</td>
</tr>
<tr>
<td>Rent for office space</td>
<td>180,000</td>
</tr>
<tr>
<td>Sales salaries and commissions</td>
<td>140,000</td>
</tr>
</tbody>
</table>

One-half of the rented premises is occupied by the sales department.

44. How much of the expenses listed above should be included in Parker’s selling expenses for 1983?

a. $290,000
b. $365,000
c. $380,000
d. $455,000

45. How much of the expenses listed above should be included in Parker’s general and administrative expenses for 1983?

a. $490,000
b. $520,000
c. $550,000
d. $580,000

1NB4#46. Wayne, Inc., incurred the following costs during the year ended December 31, 1983:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Laboratory research aimed at discovery of new knowledge</td>
<td>$150,000</td>
</tr>
<tr>
<td>Radical modification to the formulation of a chemical product</td>
<td>125,000</td>
</tr>
<tr>
<td>Research and development costs reimbursable under a contract to perform research and development for Apex Chemicals, Inc.</td>
<td>350,000</td>
</tr>
<tr>
<td>Testing for evaluation of new products</td>
<td>250,000</td>
</tr>
</tbody>
</table>

AP-52
The total amount to be classified and expensed as research and development for 1983 is:
   a. $150,000
   b. $275,000
   c. $525,000
   d. $625,000

Bergen Company purchased factory equipment which was installed and put into service January 3, 1982, at a total cost of $128,000. Salvage value was estimated at $8,000. The equipment is being depreciated over eight years by the double declining balance method. For the year 1983, how much depreciation expense should Bergen record on this equipment?
   a. $22,500
   b. $24,000
   c. $30,000
   d. $32,000

The balance in Mitchell Corporation's foreign exchange loss account was $6,500 at December 31, 1983, before any necessary year-end adjustment relating to the following:

- Mitchell had a $10,000 translation loss resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1983.

- Mitchell had an account payable to an unrelated foreign supplier payable in the local currency of the foreign supplier on January 27, 1984. The U.S. dollar equivalent of the payable was $50,000 on the November 28, 1983, invoice date, and it was $53,000 on December 31, 1983.

In Mitchell's 1983 consolidated income statement, what amount should be included as foreign exchange loss?
   a. $19,500
   b. $16,500
   c. $9,500
   d. $6,500

On January 1, 1983, Baxter Corporation granted John Eliot, the president, an option to purchase 10,000 shares of Baxter's $20 par value common stock at $30 per share. The option is intended as additional compensation to Eliot for the next two years. The option is exercisable within a four-year period beginning January 1, 1985. The market price of Baxter's common stock was $35 per share on January 1, 1983, and $37 on December 31, 1983. As a result of the stock option, Baxter should charge compensation expense in 1983 of
   a. $25,000
   b. $35,000
   c. $50,000
   d. $75,000

For the year ended December 31, 1983, Matlock Company incurred the following infrequent losses:
   - A loss of $80,000 was incurred on the abandonment of equipment used in the business.
   - A loss of $150,000 was sustained as a result of hurricane damage to a warehouse.
   - Several factories were shut down during a major strike by employees. Shutdown expenses totaled $170,000.

In its 1983 income statement, how much should Matlock report as total infrequent charges, not considered extraordinary?
   a. $80,000
   b. $170,000
   c. $250,000
   d. $400,000

Dickey Company prepared an aging of its accounts receivable at December 31, 1983, and determined that the net realizable value of the receivables at that date is $100,000. Additional information is available as follows:

| Accounts receivable, 12/31/82 | $96,000 |
| Accounts receivable, 12/31/83 | 108,000 |
| Allowance for doubtful accounts, 12/31/82 | 12,000 |
| Accounts written off as uncollectible during 1983 | 10,000 |

Dickey's bad debt expense for the year ended December 31, 1983, is
   a. $6,000
   b. $8,000
   c. $10,000
   d. $14,000

On July 1, 1981, Apgar Publishing, Inc., acquired the copyright to a book owned by Seaford Company for royalties of 20% of future sales. Royalties are payable semiannually on March 31 for sales in July through December of the preceding year, and on September 30 for sales in January through June of the same year. During 1982 and 1983, Apgar remitted the following royalty checks to Seaford:

<table>
<thead>
<tr>
<th>March 31</th>
<th>September 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>$18,000</td>
</tr>
<tr>
<td>1983</td>
<td>15,000</td>
</tr>
</tbody>
</table>

Apgar estimated that sales of the Seaford book would total $110,000 for the last half of 1983. How much royalty expense for this book should Apgar report in its 1983 income statement?
   a. $34,000
   b. $35,000
   c. $36,000
   d. $41,000
1M84#56. On December 1, 1983, Studley Company leased office space for ten years at a monthly rental of $25,000. On the same date Studley paid the lessor the following amounts:

- Security deposit (refundable upon expiration of the lease) $20,000
- First month's rent 25,000
- Last month's rent 25,000
- Installation of new walls and offices 120,000

For the year ended December 31, 1983, Studley should record expense of:
- a. $25,000
- b. $26,000
- c. $45,000
- d. $51,000

1M84#34. On September 30, 1983, a fire at Brock Company's only warehouse caused severe damage to its entire inventory. Based on recent history, Brock has a gross profit of 30% of net sales. The following information is available from Brock's records for the nine months ended September 30, 1983:

- Inventory at 1/1/83 $550,000
- Purchases 3,000,000
- Net sales 4,000,000

A physical inventory disclosed usable damaged goods which Brock estimates can be sold to a jobber for $50,000. Using the gross profit method, the estimated cost of goods sold for the nine months ended September 30, 1983, should be:
- a. $2,050,000
- b. $2,485,000
- c. $2,750,000
- d. $2,800,000

1M84#35. The following expenses were among those incurred by Sayre Company during 1983:

- Accounting and legal fees $160,000
- Interest 60,000
- Loss on sale of office equipment 25,000
- Rent for office space 200,000

One-quarter of the rented premises is occupied by the sales department. How much of the expenses listed above should be included in Sayre's general and administrative expenses for 1983?
- a. $310,000
- b. $335,000
- c. $360,000
- d. $370,000

1M84#36. Blackwood Corporation had a $20,000 translation loss adjustment resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1983. Blackwood also had a receivable from a foreign customer which was payable in the local currency of the foreign customer. On December 31, 1982, this receivable for 100,000 local currency units (LCU) was appropriately included in Blackwood's balance sheet at $55,000. When the receivable was collected on February 10, 1983, the exchange rate was 2 LCU to $1. In Blackwood's 1983 consolidated income statement, what amount should be included as foreign exchange loss?
- a. $0
- b. $5,000
- c. $20,000
- d. $25,000

1M84#37. Based on the aging of its accounts receivable at December 31, 1983, Drury Company determined that the net realizable value of the receivables at that date is $95,000. Additional information is as follows:

- Accounts receivable at 12/31/83 $110,000
- Allowance for doubtful accounts at 1/1/83 — credit balance 16,000
- Accounts written off as uncollectible at 9/30/83 12,000

Drury's bad debt expense for the year ended December 31, 1983, was:
- a. $11,000
- b. $13,000
- c. $15,000
- d. $19,000

1M84#38. During 1983 Mann Company developed a new product to be marketed beginning January 1, 1984. The following costs, incurred during 1983 in the development of this product, are expected to be recovered by December 31, 1985:

- Research and development departmental costs $365,000
- Materials and supplies consumed 110,000
- Compensation paid to research consultants 200,000

How much of the costs incurred should Mann charge to expense in 1983?
- a. $675,000
- b. $475,000
- c. $225,000
- d. $0

1M84#39. On January 1, 1983, Cody Company as lessee signed a ten-year noncancelable lease for equipment stipulating annual payments of $50,000 starting at the end of the first year. Cody appropriately treated this transaction as a capital lease. The ten lease payments have a present value of $251,000 at January 1,
Selected Questions

1983, based on implicit interest of 15%. For the year ended December 31, 1983, Cody should record interest expense of
a. $0
b. $24,900
c. $30,150
d. $37,650

1M84#41. Martin Company had the following account balances for the year ended December 31, 1983:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$120,000</td>
</tr>
<tr>
<td>Loss on disposal of noncurrent investment</td>
<td>80,000</td>
</tr>
<tr>
<td>Writedown of plant and equipment to estimated realizable value</td>
<td>60,000</td>
</tr>
</tbody>
</table>

In its income statement for 1983, how much should Martin report as total extraordinary items?

a. $0
b. $140,000
c. $180,000
d. $200,000

1M84#52. On January 1, 1983, Kipling Company paid $12,000 to White Properties as a lease bonus to obtain a four-year nonrenewable lease on premises beginning on that date. Additionally, Kipling will pay $14,000 annual rent on each December 31 throughout the term of the lease. For the year ended December 31, 1983, Kipling should report rent expense at
a. $12,000
b. $14,000
c. $17,000
d. $26,000

1M83#6. Essex Company purchased a machine on July 1, 1982, for $300,000. The machine has an estimated useful life of five years and a salvage value of $40,000. The machine is being depreciated from the date of acquisition by the 150% declining balance method. For the year ended December 31, 1982, Essex should record depreciation on this machine of
a. $39,000
b. $45,000
c. $60,000
d. $90,000

1M83#10. Frye Company incurred research and development costs in 1982 as follows:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment acquired for use in research and development projects</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Depreciation on the above equipment</td>
<td>150,000</td>
</tr>
<tr>
<td>Materials used</td>
<td>200,000</td>
</tr>
<tr>
<td>Compensation costs of personnel</td>
<td>500,000</td>
</tr>
<tr>
<td>Outside consulting fees</td>
<td>100,000</td>
</tr>
<tr>
<td>Indirect costs appropriately allocated</td>
<td>250,000</td>
</tr>
</tbody>
</table>

The total research and development costs charged in Frye’s 1982 income statement should be
a. $650,000
b. $900,000
c. $1,200,000
d. $1,800,000

1N83#11. On July 1, 1981, Stone Company lent $120,000 to a foreign supplier, evidenced by an interest bearing note due on July 1, 1982. The note is denominated in the currency of the borrower and was equivalent to 840,000 local currency units (LCU) on the loan date. The note principal was appropriately included at $140,000 in the receivables section of Stone’s December 31, 1981, balance sheet. The note principal was repaid to Stone on the July 1, 1982, due date when the exchange rate was 8 LCU to $1. In its income statement for the year ended December 31, 1982, what amount should Stone include as a foreign currency transaction gain or loss?

a. $0
b. $15,000 loss.
c. $15,000 gain.
d. $35,000 loss.

1N83#12. On January 15, 1981, Ward Company purchased 10,000 shares (10%) of the outstanding common stock of Diamond, Inc., for $25 per share. The purchase was appropriately recorded as a long-term investment and accounted for under the cost method. The market price of the stock was $24 per share on December 31, 1981. During 1982 Diamond experienced severe financial difficulties and Ward disposed of its entire investment in Diamond stock for $10 per share on November 10, 1982. Ward’s effective income tax rate was 40% for 1982. In its income statement for the year ended December 31, 1982, how much should Ward report as unusual loss from disposal of the long-term investment?

a. $150,000
b. $140,000
c. $90,000
d. $84,000

1N83#36. Effective with the year ended December 31, 1982, Grimm Company adopted a new accounting method for estimating the allowance for doubtful accounts at the amount indicated by the year-end aging of accounts receivable. The following data are available:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for doubtful accounts, 1/1/82</td>
<td>$24,000</td>
</tr>
<tr>
<td>Provision for doubtful accounts during 1982 (2% on credit sales of $1,000,000)</td>
<td>20,000</td>
</tr>
<tr>
<td>Bad debts written off, 11/30/82</td>
<td>19,500</td>
</tr>
<tr>
<td>Estimated uncollectible accounts per aging, 12/31/82</td>
<td>21,000</td>
</tr>
</tbody>
</table>
After year-end adjustment, the bad debt expense for 1982 would be
   a. $16,500
   b. $19,500
   c. $20,000
   d. $21,000

1N83#38. On January 1, 1982, Chestnut Corporation adopted a noncontributory pension plan. The actuarial consultant recommended a 7% interest rate, and applying an acceptable actuarial method, determined that the past service cost is $500,000 at January 1, 1982. The normal cost will be funded fully each year and the past service cost will be amortized and funded over 20 years. Information relating to the plan for 1982 is as follows:

   Normal pension cost $100,000
   Past service cost amortized and funded 47,200

In its income statement for the year ended December 31, 1982, Chestnut should report pension expense of
   a. $100,000
   b. $135,000
   c. $147,200
   d. $150,000

1N83#39. Marsh, Inc., has an incentive compensation plan under which the president is paid a bonus of 10% of corporate income in excess of $100,000 before income tax but after deducting the bonus. The 1982 income before income tax and bonus is $430,000. The bonus should be
   a. $39,091
   b. $36,667
   c. $33,000
   d. $30,000

1N83#40. Paulson Company had inventories at the beginning and end of 1982 as follows:

<table>
<thead>
<tr>
<th></th>
<th>1/1/82</th>
<th>12/31/82</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw materials</td>
<td>$55,000</td>
<td>$65,000</td>
</tr>
<tr>
<td>Work-in-process</td>
<td>96,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>50,000</td>
<td>85,000</td>
</tr>
</tbody>
</table>

During 1982 the following costs were incurred:

   Raw materials purchased $400,000
   Direct-labor payroll 220,000
   Factory overhead 330,000

Paulson's cost of goods sold for 1982 was
   a. $921,000
   b. $956,000
   c. $966,000
   d. $979,000

2M82#13. The following information is available for Cooke Company for 1981:

Net sales $1,800,000
Freight-in 45,000
Purchase discounts 25,000
Ending inventory 120,000

The gross margin is 40% of net sales. What is the cost of goods available for sale?
   a. $840,000
   b. $960,000
   c. $1,200,000
   d. $1,220,000

2M82#14. On January 1, 1981, Dorr Company borrowed $200,000 from its major customer, Pine Corporation, evidenced by a note payable in three years. The promissory note did not bear interest. Dorr agreed to supply Pine's inventory needs for the loan period at favorable prices. The going rate of interest for this type of loan is 14%. Assume that the present value (at the going rate of interest) of the $200,000 note is $135,000 at January 1, 1981. What amount of interest expense should be included in Dorr's 1981 income statement?
   a. $0
   b. $18,900
   c. $21,667
   d. $28,000

2M82#15. The following costs were among those incurred by Woodcroft Corporation during 1981:

   Merchandise purchased for resale $500,000
   Salesmen's commissions 40,000
   Interest on notes payable to vendors 5,000

How much should be charged to the cost of the merchandise purchases?
   a. $500,000
   b. $505,000
   c. $540,000
   d. $545,000

2M82#16. On July 1, 1982, Seco Company sold machinery to an unaffiliated company for its fair value of $275,000. Simultaneously, Seco leased back the machinery at $750 per month for five years, with no option to renew the lease or to repurchase the machinery. At July 1, 1982, this machinery had a book value of $250,000 and a remaining useful life of ten years. Seco's rent expense for this machinery for the year ended December 31, 1982, should be
   a. $0
   b. $2,000
   c. $2,500
   d. $4,500

2M82#17. In 1981 Collazo Corporation developed a new product to be marketed in 1982. The following costs were incurred during 1981 in the development of this product:
**Selected Questions**

<table>
<thead>
<tr>
<th>Research and development departmental costs</th>
<th>$400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials and supplies consumed</td>
<td>100,000</td>
</tr>
<tr>
<td>Compensation paid to research consultants</td>
<td>120,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$620,000</strong></td>
</tr>
</tbody>
</table>

These costs are expected to be recovered by 1984. How much should be charged to income in 1981 for research and development costs?

a. $0
b. $120,000
c. $500,000
d. $620,000

1N81#7. Kipling Company does not carry insurance on its office typewriters. On December 28, 1980, one of its typewriters was stolen. The book value of the typewriter at the date of the burglary was $500. On January 15, 1981, another typewriter was vandalized. The book value of that typewriter, depreciated to the date of the vandalism, was $600. On February 1, 1981, before the issuance of the 1980 financial statements, the vandalized typewriter was repaired for $120. The total amount of losses that should be charged to income in 1980 is

a. $0
b. $500
c. $620
d. $1,100

2N81#6. The following information is available for Wagner Corporation for 1980:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning inventory</td>
<td>180,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>95,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>45,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>215,000</td>
</tr>
</tbody>
</table>

How much is the cost of goods sold?

a. $200,000
b. $300,000
c. $345,000
d. $440,000

2N81#10. Tech Products, Inc., incurred the following costs during the year ended December 31, 1980:

<table>
<thead>
<tr>
<th>Laboratory research aimed at discovery of new knowledge</th>
<th>$ 7,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Design, construction, and testing of pre-production prototypes</td>
<td>9,000</td>
</tr>
<tr>
<td>Design of tools, jigs, molds, and dies involving new technology</td>
<td>15,000</td>
</tr>
<tr>
<td>Quality control during commercial production, including routine testing of products</td>
<td>18,000</td>
</tr>
</tbody>
</table>

The total amount to be classified and expensed as research and development is

a. $ 7,000
b. $22,000
c. $31,000
d. $49,000

2N81#32. U. S. Importers, Inc., bought 5,000 dolls from Latin American Exporters, S. A., at 12.5 pesos each, when the rate of exchange was $.08 per peso. How much should U. S. Importers record on its books as the total dollar cost for the merchandise purchased?

a. $ 400
b. $ 625
c. $ 5,000
d. $ 6,250

1M81#14. During 1980 Trencher, Inc., incurred research and development costs as follows:

<table>
<thead>
<tr>
<th>Experimental and development costs of a new process patented in December 1980</th>
<th>$250,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Testing for evaluation of new products</td>
<td>300,000</td>
</tr>
<tr>
<td>Modification of the formulation of a chemical product</td>
<td>150,000</td>
</tr>
<tr>
<td>Research and development costs reimbursable under a contract with Quality Chemicals Corporation</td>
<td>500,000</td>
</tr>
</tbody>
</table>

What amount should Trencher report as research and development expense in its income statement for the year ended December 31, 1980?

a. $0
b. $450,000
c. $700,000
d. $950,000

C. Provision for Income Tax

1N84#50. Bishop Corporation began operations in 1981 and had operating losses of $200,000 in 1981 and $150,000 in 1982. For the year ended December 31, 1983, Bishop had pretax book income of $300,000. For the three-year period 1981 to 1983, assume an income tax rate of 40% and no permanent or timing differences between book and taxable income. In Bishop's 1983 income statement, how much should be reported as current income tax expense?

a. $0
b. $ 40,000
c. $ 60,000
d. $120,000

1N84#59. At December 31, 1983, Tower Corporation accrued, for financial statement reporting, an estimated loss of $100,000 on disposal of unused plant equipment. During 1983 Tower collected $150,000 in royalties, of which $80,000 was unearned at December 31, 1983.
Assuming an effective income tax rate of 40%, how much should Tower report as deferred income tax credit to income for 1983?

- a. $ 8,000
- b. $32,000
- c. $40,000
- d. $72,000

1M84

Items 45 and 46 are based on the following information:

Hanson Corporation's income statement for the year ended December 31, 1983, shows pretax book income of $400,000. The following items for 1983 are treated differently on the tax return and on the books:

<table>
<thead>
<tr>
<th>Per tax return</th>
<th>Per books</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty income</td>
<td>$20,000</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>125,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>None</td>
</tr>
</tbody>
</table>

Assume that Hanson's effective tax rate for 1983 is 40%.

45. Of Hanson's total income tax expense, how much should be reported as current portion of income taxes in Hanson's 1983 income statement?

- a. $142,000
- b. $148,000
- c. $160,000
- d. $166,000

46. Of Hanson's total income tax expense, how much should be reported as deferred income taxes in Hanson's 1983 income statement?

- a. $ 8,000
- b. $10,000
- c. $12,000
- d. $18,000

2M83#8. Agard Company's effective income tax rate is 40%. For the year ended December 31, 1982, Agard's income statement reflected depletion expense of $1,000,000 based on the cost of assets being depleted. However, Agard properly deducted $4,000,000 for percentage depletion on its 1982 tax return. How much should be reported as provision for deferred income taxes in Agard's 1982 financial statements?

- a. $1,600,000
- b. $1,200,000
- c. $ 400,000
- d. $0

2M83#9. Andan Corp. purchased machinery in 1982 that qualified for an investment tax credit of $10,000. This machinery is being depreciated over a five-year period. Andan's 1982 taxable income and book income before income taxes was $250,000. Andan's effective income tax rate for 1982 was 40%. If Andan accounts for the investment tax credit by the flow-through method, how much should Andan report in its 1982 income statement for income tax expense?

- a. $ 90,000
- b. $ 96,000
- c. $ 98,000
- d. $100,000

2M83

Items 36 and 37 are based on the following information:

Bee Corp. prepared the following reconciliation between book income and taxable income for the year ended December 31, 1982:

| Income before income taxes, per books | $500,000 |
| Difference | $200,000 |
| Permanent difference — interest on municipal bonds | $ 50,000 |
| Timing difference — lower depreciation per books | 150,000 |
| Total differences | $200,000 |

Bee's effective income tax rate for 1982 is 40%. Bee reported the following information in its annual report:

| Income before income taxes | $500,000 |
| Provision for income taxes: | |
| Current | $ ? |
| Deferred | $ ? |
| Net income | $ |

36. What amount should Bee report as the current portion of its provision for income taxes?

- a. $120,000
- b. $140,000
- c. $180,000
- d. $200,000

37. What amount should Bee report as the deferred portion of its provision for income taxes?

- a. $ 20,000
- b. $ 60,000
- c. $ 80,000
- d. $120,000

1M82#15. For calendar year 1981 Steiner Corporation reported depreciation of $300,000 in its income statement. On its 1981 income tax return Steiner reported depreciation of $500,000. Additionally, Steiner's income statement included interest income of $50,000 on municipal obligations. Assuming an income tax rate of
40%, the amount of deferred taxes reported on Steiner's 1981 income statement should be
a. $ 60,000
b. $ 80,000
c. $100,000
d. $120,000

1N81#9. Lelak Company was formed on January 1, 1979. Its machinery is being depreciated using an accelerated method of depreciation for income tax reporting and the straight-line method for financial statement reporting.

Information concerning depreciation amounts under each method is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Accelerated method</th>
<th>Straight-line method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>$600,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>1980</td>
<td>800,000</td>
<td>500,000</td>
</tr>
</tbody>
</table>

Assuming that the income tax rate is 40%, the amount of deferred taxes charged to expense in Lelak's 1980 income statement should be
a. $ 40,000
b. $120,000
c. $180,000
d. $200,000

D. Recurring Versus Nonrecurring Transactions and Events

1M85#46. Farr, Inc., is disposing of a segment of its business. At the measurement date the net loss from the disposal is estimated to be $675,000. Included in this $675,000 are severance pay of $50,000 and employee relocation costs of $25,000, both of which are directly associated with the decision to dispose of the segment, and estimated operating loss of the segment to the disposal date of $100,000. A loss of $125,000 from operations from the beginning of the year to the measurement date is not included in the $675,000 estimated disposal loss. Ignoring income taxes, how much should be reported on Farr's income statement as the total loss under the heading "discontinued operations"?
  a. $225,000
  b. $625,000
  c. $650,000
  d. $800,000

1M85#48. Trent Company had net income of $700,000 for the year ended December 31, 1984, after giving effect to the following events which occurred during the year:

- Operating loss from January 1 to June 30 for the plastics manufacturing segment amounted to $60,000 before tax benefit.
- Plastics manufacturing equipment with a book value of $350,000 was sold for $200,000.
- Trent's tax rate was 40% for 1984. For the year ended December 31, 1984, Trent's after-tax income from continuing operations was
  a. $574,000
  b. $700,000
  c. $784,000
  d. $826,000

1N84#19. On May 1, 1983, an erupting volcano destroyed Wilson Company's operating plant, resulting in a loss of $1,800,000, of which only $600,000 was covered by insurance. Wilson's effective income tax rate is 40%. In Wilson's income statement for the year ended December 31, 1983, this event should be reported as an extraordinary loss of
  a. $ 480,000
  b. $ 720,000
  c. $1,200,000
  d. $1,800,000

1N84#37. Art, Inc., decided on January 1, 1983, to discontinue its cinder block manufacturing division. The division, considered a reportable segment of the business, was sold on July 1, 1983. Division assets with a carrying value of $450,000 were sold for $300,000. Operating income from January 1 to June 30, 1983, for the division amounted to $90,000. Ignoring income taxes, what amount should be reported on Art's income statement for the year ended December 31, 1983, under the caption "discontinued operations"?
  a. $ 60,000
  b. $ 90,000
  c. $150,000
  d. $240,000

1M84#42. Carr Company is indebted to Apex Company under a $700,000, 12%, four-year note dated December 31, 1980. Annual interest of $84,000 was paid on December 31, 1981, and 1982. During 1983 Carr experienced financial difficulties and is likely to default on the note and interest unless concessions are made. On December 31, 1983, Apex agreed to restructure the debt as follows:
- Interest for 1983 was reduced from $84,000 to $40,000 payable on January 31, 1984.
- Interest for 1984 was waived.
- The $700,000 principal amount was reduced to $600,000.
Ignoring income taxes, how much should Carr report as extraordinary gain on debt restructuring in its income statement for the year ended December 31, 1983?

   a. $0
   b. $ 60,000
   c. $100,000
   d. $144,000

1M84#44. On July 1, 1983, Tyler Corporation approved a formal plan to sell its plastics division, considered a segment of the business. The sale will occur in the first three months of 1984. The division had an operating loss of $400,000 for the six months ended December 31, 1983, and expects to incur a loss of $200,000 for the first quarter of 1984. The sales price is $22,000,000 and the carrying value at the date of sale should be $20,000,000. Tyler's effective tax rate for 1983 is 40%. For the year ended December 31, 1983, how much gain should Tyler report on disposal of the plastics division?

   a. $0
   b. $ 40,000
   c. $1,080,000
   d. $1,200,000

1N83#13. On May 1, 1982, the board of directors of Edgewood, Inc., approved a formal plan to sell its electronics division. The division is considered a segment of the business. It is expected that the actual sale will occur in the first three months of 1983. During 1982 the electronics division had a loss from operations of $1,200,000, which was incurred evenly during the year. Edgewood's effective tax rate for 1982 is 40%. For the year ended December 31, 1982, Edgewood should report a loss from operations of discontinued electronics division of

   a. $240,000
   b. $400,000
   c. $480,000
   d. $720,000

1N83#14. On July 1, 1982, Chatham, Inc., called for redemption of all of its $1,000,000 face amount bonds payable outstanding at the call price of 105. As of June 30, 1982, the unamortized discount was $50,000 and the unamortized bond issue costs were $30,000. The market value of the bonds was $1,060,000 on July 1, 1982. Chatham's effective income tax rate was 40% for 1982. In its income statement for the year ended December 31, 1982, what amount should Chatham report as extraordinary gain or loss from bond redemption?

   a. $0
   b. $30,000 gain.
   c. $60,000 loss.
   d. $78,000 loss.

1M83#14. Bricker Company is indebted to Springburn Bank under a $200,000, 16%, three-year note dated January 1, 1981. Interest, payable annually on December 31, was paid on the December 31, 1981, due date. During 1982 Bricker experienced severe financial difficulties and is likely to default on the note and interest unless a concession is made by the bank. On December 31, 1982, the bank agreed to settle the note and interest for 1982 for $10,000 cash and a tract of land having a current market value of $140,000. Bricker's acquisition cost of the land is $100,000. Ignoring income taxes, what amount should Bricker report as extraordinary gain on the debt restructuring in its income statement for the year ended December 31, 1982?

   a. $0
   b. $ 50,000
   c. $ 82,000
   d. $122,000

2M83#18. Palo Corporation incurred the following losses, net of applicable taxes, for the year ended December 31, 1982:

   - Loss on disposal of a segment of Palo's business $400,000
   - Loss on translation of foreign currency due to major devaluation 500,000

How much should Palo report as extraordinary losses on its 1982 income statement?

   a. $0
   b. $400,000
   c. $500,000
   d. $900,000

2M83#35. Electro Corporation had an operating loss carryforward of $250,000 at December 31, 1981, for which the benefit was fully realized at the end of 1982, when the income tax rate was 40%. For the year ended December 31, 1982, the tax benefit of the $250,000 loss carryforward should be reported as

   a. An extraordinary item of $100,000.
   b. A $100,000 reduction of 1982 income tax expense.
   c. An extraordinary item of $150,000.
   d. A $150,000 reduction of 1982 income tax expense.

2N81#35. On April 30, 1980, Empire Corporation, whose fiscal year-end is September 30, adopted a plan to discontinue the operations of Bello Division on November 30, 1980. Bello contributed a major portion of Empire's sales volume. Empire estimated that Bello would sustain a loss of $460,000 from May 1, 1980, through September 30, 1980, and would sustain an additional loss of $220,000 from October 1, 1980, to November 30, 1980. Empire also estimated that it would realize a gain of $600,000 on the sale of Bello's assets. At September 30, 1980, Empire determined that Bello had actually lost $1,120,000 for the fiscal year, of which $420,000 represented the loss from May 1 to September 30, 1980.
Ignoring income tax effects, how much should Empire report in its September 30, 1980, financial statements as gain or loss on disposal of Bello?

a. $40,000 loss.
b. $80,000 loss.
c. $180,000 gain.
d. $600,000 gain.

2NB1#39. On July 1, 1981, an erupting volcano destroyed Coastal Corporation’s operating plant, resulting in a loss of $1,500,000, of which only $500,000 was covered by insurance. Coastal’s income tax rate is 46%. How should this event be shown in Coastal’s income statement for the year ended December 31, 1981?

a. As an operating loss of $540,000, net of $460,000 income tax.
b. As an extraordinary loss of $540,000, net of $460,000 income tax.
c. As an operating loss of $1,000,000.
d. As an extraordinary loss of $1,000,000.

2M81

Items 39 and 40 are based on the following data:

Marvel Construction Co., Inc., had a net income of $600,000 for the year ended December 31, 1980, after inclusion of the following special events that occurred during the year:

- The decision was made on January 2 to discontinue the cinder block manufacturing segment.
- The cinder block manufacturing segment was actually sold on July 1.
- Operating income from January 1 to June 30 for the cinder block manufacturing segment amounted to $90,000 before taxes.
- Cinder block manufacturing equipment with a book value of $250,000 was sold for $100,000.

Marvel was subject to income tax at the rate of 40%.

39. Marvel’s after-tax income from continuing operations for the year ended December 31, 1980, was

a. $360,000
b. $564,000
c. $600,000
d. $636,000

40. Marvel’s aggregate income tax expense for the year ended December 31, 1980, should be

a. $216,000
b. $240,000
c. $264,000
d. $400,000

E. Accounting Changes

1M85#28. On December 31, 1984, Holden, Inc., appropriately changed to the FIFO cost method from the weighted-average cost method for financial statement and income tax purposes. The change will result in a $250,000 increase in the beginning inventory at January 1, 1984. Assuming a 40% income tax rate, the cumulative effect of this accounting change for the year ended December 31, 1984, is

a. $0
b. $100,000
c. $150,000
d. $250,000

1M85#49. Case Corporation purchased a machine on January 1, 1979, with an estimated useful life of ten 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, 1984, Case changed to the straight-line method for financial statement reporting but not for income tax reporting. The accumulated depreciation from January 1, 1979, through December 31, 1983, was $280,000. If the straight-line method had been used, the accumulated depreciation at December 31, 1983, would have been $210,000. Case’s effective income tax rate for the years 1979 through 1984 is 50%. The amount shown in the 1984 income statement for the cumulative effect of changing to the straight-line method would be

a. $70,000 debit.
b. $70,000 credit.
c. $35,000 credit.
d. $0.

1M84#60. On January 1, 1980, Clay Company purchased for $264,000 a machine to be depreciated by the straight-line method over the estimated useful life of eight years, with no salvage value. On January 1, 1983, Clay determined that the machine has a useful life of six years from the date of acquisition and will have a salvage value of $24,000. An accounting change was made in 1983 to reflect this additional data. The accumulated depreciation for this machine should have a balance at December 31, 1983, of

a. $176,000
b. $160,000
c. $154,000
d. $146,000

1M84#43. During 1983 White Company determined that machinery previously depreciated over a seven-year life had a total estimated useful life of only five years. An accounting change was made in 1983 to reflect the change in estimate. If the change had been made in 1982, accumulated depreciation would have been $1,600,000 at December 31, 1982, instead of $1,200,000. As a result of this change, the 1983 depreciation expense was $100,000 greater. The income tax rate was 40% in both years. What should be reported in White’s income statement for the year ended December 31, 1983, as the cumulative effect on prior years of changing the estimated useful life of the machinery?

a. $0
b. $240,000
c. $300,000
d. $400,000

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2N83#7. Patel Co. bought a patent for $300,000 on January 2, 1979, at which time the patent had an estimated useful life of 10 years. On February 2, 1982, it was determined that this patent's useful life would expire at the end of 1985. How much should Patel record as amortization expense for this patent for the year ending December 31, 1983?

a. $70,000
b. $60,000
c. $52,500
d. $30,000

2M83#19. On January 1, 1979, Cabal Company bought a machine for $1,500,000. At January 1, 1979, this machine had an estimated useful life of six years, with no salvage value. Cabal uses straight-line depreciation. As a result of additional information, Cabal determined on January 1, 1982, that the machine had an estimated useful life of eight years from the date it was acquired, with no salvage value. Accordingly, the appropriate accounting change was made in 1982. How much depreciation expense for this machine should Cabal record for the year ended December 31, 1982?

a. $125,000
b. $150,000
c. $187,500
d. $250,000

1M82#15. Effective January 1, 1981, Younger Company adopted the accounting principle of expensing as incurred advertising and promotion costs. Previously, advertising and promotion costs applicable to future periods were recorded in prepaid expenses. Younger can justify the change, which was made for both financial statement and income tax reporting purposes. Younger's prepaid advertising and promotion costs totaled $500,000 at December 31, 1980. Assume that the income tax rate is 40% for 1980 and 1981. The adjustment for the effect of this change in accounting principle should result in a net charge against income in the 1981 income statement of

a. $0
b. $200,000
c. $300,000
d. $500,000

1M81#13. On January 1, 1980, Belmont Company changed its inventory cost flow method to the FIFO cost method from the LIFO cost method. Belmont can justify the change, which was made for both financial statement and income tax reporting purposes. Belmont's inventories aggregated $4,000,000 on the LIFO basis at December 31, 1979. Supplementary records maintained by Belmont showed that the inventories would have totaled $4,800,000 at December 31, 1979, on the FIFO basis. Ignoring income taxes, the adjustment for the effect of changing to the FIFO method from the LIFO method should be reported by Belmont in the 1980

a. Income statement as an $800,000 debit.
b. Retained earnings statement as an $800,000 debit adjustment to the beginning balance.
c. Income statement as an $800,000 credit.
d. Retained earnings statement as an $800,000 credit adjustment to the beginning balance.

F. Earnings Per Share

1M85#51. Mann, Inc., had 300,000 shares of common stock issued and outstanding at December 31, 1983. On July 1, 1984, an additional 50,000 shares of common stock were issued for cash. Mann also had unexercised stock options to purchase 40,000 shares of common stock at $15 per share outstanding at the beginning and end of 1984. The average market price of Mann's common stock was $20 during 1984. What is the number
of shares that should be used in computing primary earnings per share for the year ended December 31, 1984?

a. 325,000  
b. 335,000  
c. 360,000  
d. 365,000

1N84#57. Fay Corporation's capital structure at December 31, 1982, was as follows

<table>
<thead>
<tr>
<th>Shares issued and outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
</tr>
<tr>
<td>Nonconvertible preferred stock</td>
</tr>
</tbody>
</table>

On October 1, 1983, Fay issued a 10% stock dividend on its common stock, and paid $100,000 cash dividends on the preferred stock. Net income for the year ended December 31, 1983, was $960,000. Fay's 1983 earnings per common share should be

a. $3.91  
b. $4.10  
c. $4.36  
d. $4.68

1M84#48. On January 1, 1983, Whalen, Inc., had 120,000 shares of common stock outstanding. A 10% stock dividend was issued on April 1, 1983. Whalen issued 40,000 shares of common stock for cash on July 1, 1983. What is the number of shares that should be used in computing earnings per share for the year ended December 31, 1983?

a. 146,000  
b. 149,000  
c. 152,000  
d. 172,000

1M84#49. Cox Corporation had 1,200,000 shares of common stock outstanding on January 1 and December 31, 1983. In connection with the acquisition of a subsidiary company in June 1982, Cox is required to issue 50,000 additional shares of its common stock on July 1, 1984, to the former owners of the subsidiary. Cox paid $200,000 in preferred stock dividends in 1983, and reported net income of $3,400,000 for the year. Cox's fully diluted earnings per share for 1983 should be

a. $2.83  
b. $2.72  
c. $2.67  
d. $2.56

1N83#15. Appling Company had 300,000 shares of common stock issued and outstanding at December 31, 1981. No common stock was issued during 1982. On January 1, 1982, Appling issued 200,000 shares of nonconvertible preferred stock. During 1982 Appling declared and paid $150,000 cash dividends on the common stock and $120,000 on the preferred stock. Net income for the year ended December 31, 1982, was $660,000. What should be Appling's 1982 earnings per common share?

a. $1.30  
b. $1.70  
c. $1.80  
d. $2.20

2N82

Items 17 and 18 are based on the following data:

At December 31, 1981 and 1980, Gravin Corporation had 90,000 shares of common stock and 20,000 shares of convertible preferred stock outstanding, in addition to 9% convertible bonds payable in the face amount of $2,000,000. During 1981, Gravin paid dividends of $2.50 per share on the preferred stock. The preferred stock is convertible into 20,000 shares of common stock, and is considered a common stock equivalent. The 9% convertible bonds are convertible into 30,000 shares of common stock, but are not considered common stock equivalents. Net income for 1981 was $970,000. Assume an income tax rate of 40%.

17. How much is the primary earnings per share for the year ended December 31, 1981?

a. $ 7.70  
b. $ 8.36  
c. $ 8.82  
d. $10.78

18. How much is the fully diluted earnings per share for the year ended December 31, 1981?

a. $ 7.70  
b. $ 8.21  
c. $ 9.35  
d. $10.22

1M82#11. At December 31, 1980, Welsch, Inc., had 500,000 shares of common stock outstanding. On October 1, 1981, an additional 120,000 shares of common stock were issued for cash. Welsch also had $4,000,000 of 8% convertible bonds outstanding at December 31, 1981, which are convertible into 100,000 shares of common stock. The bonds were considered common stock equivalents at the time of issuance and are dilutive in the 1981 earnings per share computation. No bonds were issued or converted into common stock during 1981. What is the number of shares that should be used in computing primary earnings per share for the year ended December 31, 1981?

a. 530,000  
b. 600,000  
c. 630,000  
d. 720,000

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Accounting Practice

1M81#12. Redford Corporation’s capital structure at December 31, 1979, was as follows:

<table>
<thead>
<tr>
<th>Shares issued and outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
</tr>
<tr>
<td>Nonconvertible preferred stock</td>
</tr>
</tbody>
</table>

On July 1, 1980, Redford issued a 10% stock dividend on its common stock, and paid a cash dividend of $2.00 per share on its preferred stock. Net income for the year ended December 31, 1980, was $780,000. What should be Redford’s 1980 earnings per common share?

a. $6.73  
b. $7.05  
c. $7.09  
d. $7.80

1M81#18. At December 31, 1979, Sonic Company had 20,000 shares of common stock issued and outstanding and 5,000 shares of nonconvertible preferred stock issued and outstanding. Sonic’s net income for the year ended December 31, 1980, was $120,000. During 1980 Sonic declared and paid $50,000 cash dividends on common stock and $8,000 cash dividends on the nonconvertible preferred stock. There were no common stock or preferred stock transactions during the year. The earnings per common share for the year ended December 31, 1980, should be

2M81#23. The following capital stock information pertains to Palisades Corporation:

<table>
<thead>
<tr>
<th>Number of shares issued</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $10 par value; 300,000 shares authorized:</td>
<td></td>
</tr>
<tr>
<td>January 1, 1980</td>
<td>45,000</td>
</tr>
<tr>
<td>Sold on May 1, 1980</td>
<td>3,000</td>
</tr>
<tr>
<td>Total, December 31, 1980</td>
<td>48,000</td>
</tr>
<tr>
<td>Preferred stock, 9% cumulative nonconvertible, $100 par value; 10,000 shares authorized</td>
<td></td>
</tr>
<tr>
<td>The number of shares on which the 1980 earnings per share computation should be based is</td>
<td></td>
</tr>
<tr>
<td>a. 46,500</td>
<td></td>
</tr>
<tr>
<td>b. 47,000</td>
<td></td>
</tr>
<tr>
<td>c. 48,000</td>
<td></td>
</tr>
<tr>
<td>d. 49,000</td>
<td></td>
</tr>
</tbody>
</table>

VI. Other Financial Topics

C. Nonmonetary Transactions

1M85#52. In January 1984 Bell Company exchanged an old machine, with a book value of $39,000 and a fair value of $35,000, and paid $10,000 cash for a similar used machine having a list price of $50,000. At what amount should the machine acquired in the exchange be recorded on the books of Bell?

a. $45,000  
b. $46,000  
c. $49,000  
d. $50,000

2N84#3. On December 1, 1983, Brint Corp. exchanged 4,000 shares of its $25 par value common stock held in treasury, for a parcel of land to be held for a future plant site. These treasury shares, which were acquired by Brint at a cost of $80 per share, had a fair market value of $110 per share on the date of the exchange. At what amount should the land be recorded on Brint’s books?

a. $0 (Memorandum entry only)  
b. $100,000

2N84#8. Lara Co. traded its old computer for a new model. The following information is pertinent to this transaction:

<table>
<thead>
<tr>
<th>Cost of old computer</th>
<th>$60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated depreciation—old computer</td>
<td>20,000</td>
</tr>
<tr>
<td>Fair value of old computer</td>
<td>30,000</td>
</tr>
<tr>
<td>List price of new model</td>
<td>80,000</td>
</tr>
<tr>
<td>Trade-in allowance for old computer</td>
<td>45,000</td>
</tr>
</tbody>
</table>

How much loss should Lara immediately recognize on this trade-in?

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

1M84#50. On December 30, 1983, Diamond Company traded in an old machine with a book value of $10,000 for a similar new machine having a list price
Selected Questions

of $32,000, and paid a cash difference of $19,000. Diamond should record the new machine at
a. $32,000
b. $29,000
c. $22,000
d. $19,000

1M84#51. On October 10, 1983, Girard, Inc., exchanged 2,000 shares of its $50 par value common stock held in treasury for a patent owned by Waxman Company. The treasury shares were acquired in 1982 at a cost of $80,000. At the exchange date Girard's common stock was quoted at $55 per share and the patent had a net carrying value on Waxman's books of $90,000. Girard should record the patent at
a. $80,000
b. $90,000
c. $100,000
d. $110,000

1M83#9. In October 1982 Ewing Company exchanged an old packaging machine, which cost $120,000 and was 50% depreciated, for a dissimilar used machine and paid a cash difference of $16,000. The market value of the old packaging machine was determined to be $70,000. For the year ended December 31, 1982, what amount of gain or loss should Ewing recognize on this exchange?
    a. $0
    b. $6,000 loss.
    c. $10,000 loss.
    d. $10,000 gain.

1M83#16. Madden Company owns a tract of land which it purchased in 1980 for $100,000. The land is held as a future plant site and has a fair market value of $140,000 on July 1, 1983. Hall Company also owns a tract of land held as a future plant site. Hall paid $180,000 for the land in 1982 and the land has a fair market value of $200,000 on July 1, 1983. On this date Madden exchanged its land and paid $50,000 cash for the land owned by Hall. At what amount should Madden record the land acquired in the exchange?
    a. $150,000
    b. $160,000
    c. $190,000
    d. $200,000

2M83#2. On September 1, 1982, Bertz, Inc., exchanged a delivery truck for a parcel of land. Bertz bought this truck in 1980 for $10,000. At September 1, 1982, the truck had a book value of $6,500 and a fair market value of $5,000. Bertz gave $6,000 in cash in addition to the truck as part of this transaction. The previous owner of the land had listed the land for sale at $12,000. At what amount should Bertz record the land?

1M83#15. In December 1980 Belmont Company exchanged an old bottling machine, which cost $80,000 and was two-thirds depreciated, for a similar used machine having a current fair value of $24,000, and received a cash difference of $8,000. What is the amount of gain that Belmont should recognize on this exchange in the year ended December 31, 1980?
    a. $0
    b. $3,000
    c. $5,000
    d. $8,000

2M81#8. On December 1, 1980, Leonard Company exchanged a delivery truck (that was acquired in 1976) for a new delivery truck. The old truck was purchased for $14,000 and had a book value of $5,600. On the date of the exchange the old truck had a market value of $6,000. In addition, Leonard paid $7,000 cash for the new truck, which had a list price of $16,000. At what amount should Leonard record the new truck for financial accounting purposes?
    a. $10,000
    b. $12,600
    c. $13,000
    d. $16,000

D. Interim Financial Statements

1M85#47. An inventory loss from market decline of $720,000 occurred in May 1984. King Company appropriately recorded this loss in May 1984 after its March 31, 1984, quarterly report was issued. How much of the inventory loss should be reflected in King's quarterly income statement for the three months ended June 30, 1984?
    a. $720,000
    b. $360,000
    c. $180,000
    d. $0

1M85#53. The first week of January 1984 Bolton Company made unanticipated repairs to its plant equipment at a cost of $240,000. These repairs will benefit operations for the remainder of the calendar year. On March 15, 1984, Bolton paid property taxes of $120,000 on its factory building for calendar year 1984. What total amount of these expenses should be included in Bolton's quarterly income statement for the three months ended March 31, 1984?
    a. $90,000
    b. $180,000
    c. $270,000
    d. $360,000
Richland Company uses the retail inventory method to estimate its inventory for interim statement purposes. Data relating to the computation of the inventory at July 31, 1983, are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 2/1/83</td>
<td>$70,000</td>
<td>$110,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>350,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Additional markups</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>600,000</td>
<td></td>
</tr>
<tr>
<td>Estimated normal shoplifting losses</td>
<td>10,000</td>
<td></td>
</tr>
</tbody>
</table>

Under the approximate lower of average cost or market retail method, Richland’s estimated inventory at July 31, 1983, is:

a. $90,000
b. $63,000
c. $60,000
d. $54,000

In January 1983 Lee Corp. paid property taxes of $40,000 covering the calendar year 1983. Also in January 1983, Lee estimated that its year-end bonuses to executives would amount to $160,000 for 1983. What is the total amount of expense relating to these two items that should be reflected in Lee’s quarterly income statement for the three months ended June 30, 1983?

a. $0
b. $10,000
c. $40,000
d. $50,000

Ross Corporation expects to sustain an operating loss of $100,000 for the full year ending December 31, 1983. Ross operates entirely in one jurisdiction where the tax rate is 40%. Anticipated tax credits for 1983 total $10,000. No permanent differences are expected. Realization of the full tax benefit of the expected operating loss and realization of anticipated tax credits are assured beyond any reasonable doubt because they will be carried back. For the first quarter ended March 31, 1983, Ross reported an operating loss of $20,000. How much of a tax benefit should Ross report for the interim period ended March 31, 1983?

a. $0
b. $8,000
c. $10,000
d. $12,500

On January 15, 1980, Forrester Company paid property taxes on its factory building for the calendar year 1980 in the amount of $60,000. The first week of April 1980 Forrester made unanticipated major repairs to its plant equipment at a cost of $240,000. These repairs will benefit operations for the remainder of the calendar year. How should these expenses be reflected in Forrester’s quarterly income statements?

<table>
<thead>
<tr>
<th>Three months ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 1980</td>
</tr>
<tr>
<td>June 30, 1980</td>
</tr>
<tr>
<td>September 30, 1980</td>
</tr>
<tr>
<td>December 31, 1980</td>
</tr>
<tr>
<td>a. $15,000</td>
</tr>
<tr>
<td>b. $15,000</td>
</tr>
<tr>
<td>c. $60,000</td>
</tr>
<tr>
<td>d. $75,000</td>
</tr>
<tr>
<td>$95,000</td>
</tr>
<tr>
<td>$15,000</td>
</tr>
<tr>
<td>$240,000</td>
</tr>
<tr>
<td>$75,000</td>
</tr>
<tr>
<td>$95,000</td>
</tr>
<tr>
<td>$15,000</td>
</tr>
<tr>
<td>$0</td>
</tr>
<tr>
<td>$15,000</td>
</tr>
</tbody>
</table>

Information with respect to Wilson Company’s cost of goods sold for 1984 is as follows:

<table>
<thead>
<tr>
<th>Historical cost</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/84</td>
<td>$1,060,000</td>
</tr>
<tr>
<td>Production during 1984</td>
<td>5,580,000</td>
</tr>
<tr>
<td>Inventory, 12/31/84</td>
<td>6,640,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>4,750,000</td>
</tr>
</tbody>
</table>

Wilson estimates that the current cost per unit of inventory was $58 at January 1, 1984, and $72 at December 31, 1984. In Wilson’s supplementary information restated into average current cost, the cost of goods sold for 1984 should be:

a. $4,640,000
b. $5,040,000
c. $5,200,000
d. $5,760,000

Items 9 and 10 are based on the following data:

The trial balance of Sosa Corp. at December 31, 1983, when the price index was 160, included the following accounts:

| Bonds payable (due in 1988) | $200,000 |
| Sales (made evenly throughout the year) | 990,000 |

During 1983, the average price index was 140. The bonds were issued in 1978 when the price index was 120. Sosa wishes to present December 31, 1983, constant dollar financial statements in end-of-year dollars.

What fraction should be used to adjust bonds payable for price-level changes?

a. 140/160
b. 160/160
c. 160/140
d. 160/120
10. What fraction should be used to adjust sales for price-level changes?
   a. 160/160
   b. 160/150
   c. 160/140
   d. 140/160

**1N84#59.** Details of Weaver Corporation’s fixed assets at December 31, 1983, are as follows:

<table>
<thead>
<tr>
<th>Year acquired</th>
<th>Percent depreciated</th>
<th>Historical cost</th>
<th>Estimated current cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>30</td>
<td>$100,000</td>
<td>$140,000</td>
</tr>
<tr>
<td>1982</td>
<td>20</td>
<td>30,000</td>
<td>38,000</td>
</tr>
<tr>
<td>1983</td>
<td>10</td>
<td>40,000</td>
<td>44,000</td>
</tr>
</tbody>
</table>

Weaver calculates depreciation at 10% per annum, using the straight-line method. A full year’s depreciation is charged in the year of acquisition. There were no disposals of fixed assets. In Weaver’s supplementary information restated into current cost, the net current cost (after accumulated depreciation) of the fixed assets should be stated as
   a. $116,000
   b. $130,000
   c. $168,000
   d. $182,000

**1N83#17.** On January 1, 1982, Nutley Corporation had monetary assets of $2,000,000 and monetary liabilities of $1,000,000. During 1982, Nutley’s monetary inflows and outflows were relatively constant and equal so that it ended the year with net monetary assets of $1,000,000. Assume that the Consumer Price Index was 200 on January 1, 1982, and 220 on December 31, 1982. In end-of-year constant dollars, what is Nutley’s purchasing power gain or loss on net monetary items for 1982?
   a. $0
   b. $50,000 gain
   c. $100,000 gain
   d. $100,000 loss

**2M83#15.** Loy Corp. purchased a machine in 1980 when the average Consumer Price Index (CPI) was 180. The average CPI was 190 for 1981, and 200 for 1982. Loy prepares supplementary constant dollar statements (adjusted for changing prices). Depreciation on this machine is $200,000 a year. In Loy’s supplementary constant dollar statement for 1982, the amount of depreciation expense should be stated as
   a. $180,000
   b. $190,000
   c. $210,526
   d. $222,222

**2M82#8.** Essex Corporation bought a machine for $105,000 on January 3, 1981. The machine has an estimated useful life of ten years, with no salvage value. The current cost of this machine at December 31, 1981, was $135,000. Using straight-line depreciation on an average current cost basis, how much depreciation should be charged to current cost income from continuing operations for 1981?
   a. $10,500
   b. $12,000
   c. $13,500
   d. $24,000

**1N81#6.** Cartwright Corporation prepared the following data needed to compute the purchasing power gain or loss on net monetary items for inclusion in its supplementary information for the year ended December 31, 1980:

<table>
<thead>
<tr>
<th>Amount in nominal dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1979</td>
</tr>
<tr>
<td>Monetary assets</td>
</tr>
<tr>
<td>Monetary liabilities</td>
</tr>
<tr>
<td>Net monetary liabilities</td>
</tr>
</tbody>
</table>

Assumed Consumer Price Index numbers:
   At December 31, 1979: 210
   At December 31, 1980: 230
   Average for 1980: 220

Cartwright’s purchasing power gain or loss (expressed in average 1980 constant dollars) on net monetary items for the year ended December 31, 1980, should be
   a. $109,000 gain
   b. $109,000 loss
   c. $111,000 gain
   d. $111,000 loss

**1N81#17.** Information with respect to Roundtree Company’s cost of goods sold for 1980 is as follows:

<table>
<thead>
<tr>
<th>Units</th>
<th>Historical cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, January 1, 1980</td>
<td>10,000</td>
</tr>
<tr>
<td>Production during 1980</td>
<td>45,000</td>
</tr>
<tr>
<td>Inventory, December 31, 1980</td>
<td>55,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td>40,000</td>
</tr>
</tbody>
</table>

Roundtree estimates that the current cost per unit of inventory was $58 at January 1, 1980, and $72 at December 31, 1980. In Roundtree’s supplementary information restated into average current cost, the cost of goods sold for the year ended December 31, 1980, should be
   a. $2,290,000
   b. $2,520,000
   c. $2,600,000
   d. $2,880,000
2M81#1. The following schedule lists the average consumer price index (all urban consumers) of the indicated year:

<table>
<thead>
<tr>
<th>Year</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>100</td>
</tr>
<tr>
<td>1979</td>
<td>125</td>
</tr>
<tr>
<td>1980</td>
<td>150</td>
</tr>
</tbody>
</table>

Carl Corporation's plant and equipment at December 31, 1980, are as follows:

<table>
<thead>
<tr>
<th>Date acquired</th>
<th>Percent depreciated</th>
<th>Historical cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>30</td>
<td>$30,000</td>
</tr>
<tr>
<td>1979</td>
<td>20</td>
<td>20,000</td>
</tr>
<tr>
<td>1980</td>
<td>10</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$60,000</td>
</tr>
</tbody>
</table>

Depreciation is calculated at 10% per annum, straight-line. A full year's depreciation is charged in the year of acquisition. There were no disposals in 1980.

What amount of depreciation expense would be included in the income statement adjusted for general inflation (historical cost/constant dollar accounting)?

a. $6,000  
b. $7,200  
c. $7,900  
d. $9,000

F. Gain Contingencies

1M84#58. In May 1980 Tooker Company filed suit against Rogers Corporation seeking to recover $1,000,000 for copyright infringement. A court verdict rendered in September 1983 awarded Tooker $700,000 in damages. Rogers appealed the verdict but a final decision is not expected before October 1984. Tooker's counsel believes it is probable that Tooker will be successful against Rogers for an estimated amount of $500,000. What amount should Tooker accrue by a credit to income in the year ended December 31, 1983?

a. $0  
b. $500,000  
c. $600,000  
d. $700,000

1M82#20. In July 1977 Simpson Company filed suit in federal court against White Corporation seeking to recover $750,000 for patent infringement. A court verdict was rendered in August 1981 awarding Simpson $500,000 in damages. White has appealed the verdict but a final decision is not expected before October 1982. Simpson's counsel believes it is probable that Simpson will be successful against White for an estimated amount of $400,000. What amount should Simpson accrue by a credit to income in the year ended December 31, 1981?

a. $0  
b. $400,000  
c. $500,000  
d. $750,000

G. Segments and Lines of Business

1M85#55. Mill, Inc., reports operating profit as to industry segments in its supplementary financial information annually. The following data are available for 1984:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales</th>
<th>Traceable costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$1,500,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>B</td>
<td>1,000,000</td>
<td>450,000</td>
</tr>
<tr>
<td>C</td>
<td>500,000</td>
<td>250,000</td>
</tr>
<tr>
<td></td>
<td>$3,000,000</td>
<td>$1,600,000</td>
</tr>
</tbody>
</table>

Additional expenses not included above are as follows:

- Indirect operating expenses: $480,000
- General corporate expenses: $300,000
- Other expense (net): $96,000
Mill allocates common costs based on the ratio of a segment's sales to total sales. What should be the operating profit for segment A for 1984?

a. $162,000
b. $210,000
c. $312,000
d. $360,000

2N84#4. Daly Corporation's sales to unaffiliated customers were $3,000,000 for the year ended December 31, 1983. In addition, there were $400,000 of intersegment sales and transfers among Daly's four manufacturing divisions operating in different industries. Daly's reportable industry segments are those divisions with revenues of at least:

a. $40,000
b. $100,000
c. $300,000
d. $340,000

2N84#5. Orna Corp. operates in six different industries, each of which is appropriately regarded as a reportable segment. Orna's 1983 combined sales for all segments aggregated $10,000,000. Segment No. 4 had sales of $2,000,000 and traceable costs of $900,000. Combined common costs for all segments totaled $3,000,000. Common costs are allocated among the six segments on the basis of each segment's percentage of Orna's total sales, an acceptable allocation method. How much should be reported as Segment No. 4's operating income for 1983?

a. $500,000
b. $1,100,000
c. $1,220,000
d. $1,400,000

1N82#20. Hines Corporation reports operating profit as to industry segments in its supplementary financial information annually. The following information is available for 1981:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales</th>
<th>Traceable costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>750,000</td>
<td>450,000</td>
</tr>
<tr>
<td>B</td>
<td>500,000</td>
<td>225,000</td>
</tr>
<tr>
<td>C</td>
<td>250,000</td>
<td>125,000</td>
</tr>
<tr>
<td></td>
<td>1,500,000</td>
<td>800,000</td>
</tr>
</tbody>
</table>

Additional expenses not included above are as follows:

- Indirect operating expenses: $240,000
- General corporate expenses: $180,000
- Interest expense: $96,000

Hines allocates common costs based on the ratio of a segment's sales to total sales. What should be the operating profit for segment B for 1981?

a. $103,000
b. $135,000
c. $163,000
d. $195,000

2M82#16. Kaycee Corporation's revenues for the year ended December 31, 1981, were as follows:

- Consolidated revenue per income statement: $1,200,000
- Intersegment sales: $180,000
- Intersegment transfers: $60,000
- Combined revenues of all industry segments: $1,440,000

Kaycee has a reportable segment if that segment's revenues exceed:

- $6,000
- $24,000
- $120,000
- $144,000

2N83#4. Kee Co. has five 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 Kee's aggregate sales. Kee's Sigma division comprised 40% of Kee's total sales in 1982. For the year ended December 31, 1982, Sigma had sales of $1,000,000 and traceable costs of $600,000. In 1982, Kee incurred operating expenses of $100,000 that were not directly traceable to any of the five divisions. In addition, Kee incurred interest expense of $80,000 in 1982. In reporting supplementary segment information, how much should be shown as Sigma's operating income for 1982?

a. $300,000
b. $328,000
c. $360,000
d. $400,000
1M81#4. Plains, Inc., engages in three lines of business, each of which is considered to be a significant industry segment. Company sales aggregated $1,800,000 in 1980, of which Segment No. 3 contributed 60%. Traceable costs were $600,000 for Segment No. 3 out of a total of $1,200,000 for the company as a whole. In addition $350,000 of common costs are allocated based on the ratio of a segment's income before common costs to the total income before common costs. What should Plains report as operating profit for Segment No. 3 in 1980?
   a. $200,000
   b. $270,000
   c. $280,000
   d. $480,000

H. Employee Benefits

1M85#56. Lewis Company adopted a pension plan on January 1, 1983, on a funded, noncontributory basis. Lewis elected to amortize past service cost over 15 years and to fund past service cost over 20 years. Normal cost is to be funded as incurred each year. Data for the first two years of the plan are as follows:

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-year amortization</td>
<td>$29,900</td>
<td>$29,900</td>
</tr>
<tr>
<td>Addition for interest</td>
<td>—</td>
<td>250</td>
</tr>
<tr>
<td>Past service cost</td>
<td>29,900</td>
<td>30,150</td>
</tr>
<tr>
<td>20-year funding</td>
<td>24,900</td>
<td>24,900</td>
</tr>
<tr>
<td>Balance sheet liability:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase for year</td>
<td>5,000</td>
<td>5,250</td>
</tr>
<tr>
<td>Balance</td>
<td>5,000</td>
<td>10,250</td>
</tr>
</tbody>
</table>

If normal cost for 1984 was $26,500, how much pension expense should Lewis record for 1984?
   a. $24,900
   b. $51,400
   c. $56,400
   d. $56,650

1M84#55. Lenox Company has a retirement savings plan which provides that: (1) eligible employees may deposit up to 5% of their salaries through payroll deduction, and (2) the company is required to make an annual contribution of an amount equal to 50% of the participants' deposits. Data for the year ended December 31, 1983, relating to eligible employees are as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total salaries</td>
<td>$750,000</td>
</tr>
<tr>
<td>Total employee deposits made</td>
<td>25,000</td>
</tr>
</tbody>
</table>

What amount should Lenox report as retirement savings plan expense for 1983?
   a. $0
   b. $12,500
   c. $18,750
   d. $25,000

2M83

6. If normal cost for 1981 was $90,000, how much pension expense should Stevenson record for 1981?
   a. $ 90,000
   b. $109,628
   c. $190,000
   d. $199,628

7. If normal cost in 1982 was $95,000, what entry should Stevenson make in 1982 to record pension expense and funding?

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Pension expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred charge—funding in excess of cost</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$9,628</td>
<td></td>
</tr>
<tr>
<td>b. Pension expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred charge—funding in excess of cost</td>
<td>$193,845</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$109,628</td>
<td></td>
</tr>
<tr>
<td>c. Pension expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred charge—funding in excess of cost</td>
<td>$195,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$204,628</td>
<td></td>
</tr>
<tr>
<td>d. Pension expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred charge—funding in excess of cost</td>
<td>$195,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$205,783</td>
<td></td>
</tr>
</tbody>
</table>

2M83#13. Lucro Company pays a general manager's bonus based on 10% of Lucro's income after deducting the bonus but before deducting income taxes. For the
Selected Questions

2N84#7 The following information pertains to Bass Co. for 1983:

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise purchased</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Inventory at December 31, 1983</td>
<td>400,000</td>
</tr>
</tbody>
</table>

The inventory turnover for 1983 was

a. 10.0  
b. 5.0  
c. 4.0  
d. 3.6

1M84#56. Selected information for Moore Corporation is as follows:

<table>
<thead>
<tr>
<th>December 31</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1982</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>$180,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>648,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>192,000</td>
</tr>
<tr>
<td>Net income for year ended</td>
<td>144,000</td>
</tr>
</tbody>
</table>

What is Moore's rate of return on average stockholders' equity for 1983?

a. 16.0%  
b. 20.0%  
c. 23.5%  
d. 26.0%

1N83#18. Selected information from the accounting records of Dalton Manufacturing Company is as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales for 1982</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Cost of goods sold for 1982</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Inventories at December 31, 1981</td>
<td>336,000</td>
</tr>
<tr>
<td>Inventories at December 31, 1982</td>
<td>288,000</td>
</tr>
</tbody>
</table>

Assuming there are 300 working days per year, what is the number of days' sales in average inventories for 1982?

a. 78  
b. 72  
c. 52  
d. 48

2N83#19. Barr Corporation's capital stock at December 31, 1982, consisted of the following:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $2 par value; 100,000 shares authorized, issued, and outstanding</td>
<td></td>
</tr>
<tr>
<td>10% noncumulative, nonconvertible preferred stock, $100 par value; 1,000 shares authorized, issued, and outstanding</td>
<td></td>
</tr>
</tbody>
</table>

Barr's common stock, which is listed on a major stock exchange, was quoted at $4 per share on December 31,
1982. Barr's net income for the year ended December 31, 1982, was $50,000. The 1982 preferred dividend was declared. No capital stock transactions occurred during 1982. What was the price-earnings ratio on Barr's common stock at December 31, 1982?

a. 8 to 1.
b. 10 to 1.
c. 16 to 1.
d. 20 to 1.

2N83#20. Ace Company's working capital at December 31, 1981, was $5,000,000. The following additional information pertains to Ace for 1982:

Working capital provided by operations $850,000
Capital expenditures 1,500,000
Short-term borrowings 500,000
Long-term borrowings 1,000,000
Payments on short-term borrowings 250,000
Payments on long-term borrowings 300,000
Proceeds from issuance of common stock 700,000
Dividends paid on common stock 400,000

How much was Ace's working capital at December 31, 1982?

a. $5,350,000
b. $5,600,000
c. $5,750,000
d. $6,000,000

2M83 Items 24 through 30 are based on the following information:

Best Corporation
INCOME STATEMENTS

Year ended December 31,
1982 1981

Credit sales $6,300,000 $4,000,000
Cost of goods sold 4,900,000 3,200,000
Gross profit 1,400,000 800,000
Expenses (including income taxes) 700,000 630,000
Net income $700,000 $170,000

Best Corporation
BALANCE SHEETS

December 31,
1982 1981

Assets
Current assets:
Cash $480,000 $220,000
Accounts receivable—net 840,000 560,000
Merchandise inventory 760,000 470,000
Total current assets 2,080,000 1,250,000
Land, buildings, and fixtures 1,330,000 800,000
Less accumulated depreciation 210,000 150,000
Total assets $3,200,000 $1,900,000

Best Corporation
CHANGES IN STOCKHOLDERS' EQUITY

Year ended December 31,
1982 1981

Common stock
Balance, 1/1 $900,000 $900,000
Sold, 4/1/82 100,000 —
20% stock dividend, 6/1/82 200,000 —
Balance, 12/31 1,200,000 900,000

Additional paid-in capital
Balance, 1/1 $100,000 $100,000
Sold, 4/1/82 25,000 —
20% stock dividend, 6/1/82 75,000 —
Balance, 12/31 200,000 100,000

Best Corporation
BALANCE SHEETS

December 31,
1982 1981

Assets
Current assets:
Cash $480,000 $220,000
Accounts receivable—net 840,000 560,000
Merchandise inventory 760,000 470,000
Total current assets 2,080,000 1,250,000
Land, buildings, and fixtures 1,330,000 800,000
Less accumulated depreciation 210,000 150,000
Total assets $3,200,000 $1,900,000

Liabilities and stockholders' equity
Current liabilities:
Accounts payable $830,000 $440,000
Accrued expenses 300,000 130,000
Dividends payable 40,000 —
Total current liabilities 1,170,000 570,000
Stockholders' equity:
Common stock ($10 par value) 1,200,000 900,000
Additional paid-in capital 200,000 100,000
Retained earnings 630,000 330,000
Total liabilities and stockholders' equity $3,200,000 $1,900,000

Accounting Practice
Selected Questions

**Year ended December 31, 1982**

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>1982</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 1/1</td>
<td>$330,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Net income</td>
<td>700,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Cash dividends</td>
<td>(125,000)</td>
<td>(90,000)</td>
</tr>
<tr>
<td>Stock dividends</td>
<td>(275,000)</td>
<td>—</td>
</tr>
<tr>
<td>Balance, 12/31</td>
<td>$630,000</td>
<td>$330,000</td>
</tr>
</tbody>
</table>

Additional available information included the following:

- Although Best will report all changes in financial position, management has adopted a format emphasizing the flow of working capital.

- During 1982, Best sold, at a $10,000 loss, fixtures with a book value of $30,000 ($100,000 cost minus $70,000 accumulated depreciation). This loss was included in the income statement. Depreciation expense for 1982 was $130,000. Best purchased $630,000 of new fixtures during 1982.

- Common stock issued during 1982 was as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Number of shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/1/82</td>
<td>10,000</td>
</tr>
<tr>
<td>6/1/82</td>
<td>20,000</td>
</tr>
</tbody>
</table>

28. Best’s current ratio at December 31, 1982, is
   a. 0.56
   b. 0.89
   c. 1.13
   d. 1.78

29. Best’s 1982 accounts receivable turnover is
   a. 5.83
   b. 7.00
   c. 7.50
   d. 9.00

30. Best debited retained earnings on June 1, 1982, for the market value of the stock dividend. The market value per share of Best’s common stock on June 1, 1982, was
   a. $10.00
   b. $13.75
   c. $25.00
   d. $30.00

9. Bretton’s accounts receivable turnover is
   a. 2.9 times.
   b. 3.6 times.
   c. 4.0 times.
   d. 5.0 times.

10. Bretton’s percent of net income on sales is
   a. 4%
   b. 9%
   c. 44%
   d. 56%

**1M82**

Items 16 and 17 are based on the following information:

Tudor Corporation’s condensed financial statements provide the following information:

**Balance Sheet**
December 31, 1981 and 1980

<table>
<thead>
<tr>
<th></th>
<th>1981</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$60,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>220,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>260,000</td>
<td>230,000</td>
</tr>
<tr>
<td>Property, plant and</td>
<td>730,000</td>
<td>650,000</td>
</tr>
<tr>
<td>equipment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(330,000)</td>
<td>(260,000)</td>
</tr>
<tr>
<td>Total assets</td>
<td>$940,000</td>
<td>$870,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1981</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td>$270,000</td>
<td>$330,000</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td>670,000</td>
<td>540,000</td>
</tr>
<tr>
<td>Total liabilities and</td>
<td>$940,000</td>
<td>$870,000</td>
</tr>
<tr>
<td>stockholders’ equity</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Statement of Income**
For the Year Ended December 31, 1981

<table>
<thead>
<tr>
<th></th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>780,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>420,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>240,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$180,000</td>
</tr>
</tbody>
</table>

**AP-73**
16. Assuming that all sales are credit sales, what is Tudor's accounts receivable turnover ratio for 1981?
   a. 3.18
   b. 5.45
   c. 5.71
   d. 6.00

17. What is Tudor's rate of return on average assets for 1981?
   a. 14.17%
   b. 19.15%
   c. 19.89%
   d. 29.75%

2M81
Items 15 through 18 are based on the following information:

**Alpha Corporation**

*Selected Financial Data*

<table>
<thead>
<tr>
<th></th>
<th>As of December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1980</td>
<td>1979</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$10,000</td>
<td>$80,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>50,000</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>90,000</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Short-term marketable securities</td>
<td>30,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Land and buildings (net)</td>
<td>340,000</td>
<td>360,000</td>
<td></td>
</tr>
<tr>
<td>Mortgage payable (no current portion)</td>
<td>270,000</td>
<td>280,000</td>
<td></td>
</tr>
<tr>
<td>Accounts payable (trade)</td>
<td>70,000</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td>Short-term notes payable</td>
<td>20,000</td>
<td>40,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1980</td>
<td>1979</td>
<td></td>
</tr>
<tr>
<td>Cash sales</td>
<td>$1,800,000</td>
<td>$1,600,000</td>
<td></td>
</tr>
<tr>
<td>Credit sales</td>
<td>500,000</td>
<td>800,000</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,000,000</td>
<td>1,400,000</td>
<td></td>
</tr>
</tbody>
</table>

15. Alpha's quick (acid test) ratio as of December 31, 1980, is
   a. 0.5 to 1.
   b. 0.7 to 1.
   c. 1.0 to 1.
   d. 2.0 to 1.

16. Alpha's receivable turnover for 1980 is
   a. 5 times.
   b. 10 times.
   c. 23 times.
   d. 46 times.

17. Alpha's merchandise inventory turnover for 1980 is
   a. 8.3 times.
   b. 10.0 times.
   c. 11.1 times.
   d. 13.3 times.

18. Alpha's current ratio at December 31, 1980, is
   a. 0.5 to 1.
   b. 0.7 to 1.
   c. 1.0 to 1.
   d. 2.0 to 1.

**K. Personal Financial Statements**

1M85#60. Mr. & Mrs. Dean require a personal statement of financial condition as of December 31, 1984. Included in their assets at this date are the following:

- A $300,000 whole life insurance policy (on Mr. Dean) having a cash value of $43,000 at December 31, 1984, subject to a $37,000 loan payable to the insurance company.

- A residence purchased in 1980 at a cost of $150,000. Similar homes in the area are currently selling at approximately $175,000.

In the Deans' December 31, 1984, personal statement of financial condition, the above assets should be reported at a total amount of

   a. $218,000
   b. $193,000
   c. $181,000
   d. $156,000

1M84#57. Mr. & Mrs. Carson are applying for a bank loan and the bank has requested a personal statement of financial condition as of December 31, 1983. Included in their assets at this date are the following:

- 1,000 shares of Alden Corporation common stock purchased in 1980 at a cost of $50,000. The quoted market value of the stock was $75 per share on December 31, 1983.

- A residence purchased in 1981 at a cost of $120,000. Improvements costing $15,000 were made in 1982. Unimproved similar homes in the area are currently selling at approximately the same price levels as in 1981.

In the Carsons' December 31, 1983, personal statement of financial condition, the above assets should be reported at a total amount of

   a. $170,000
   b. $185,000
   c. $195,000
   d. $210,000
VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

2N84#13. Avery Co. uses a predetermined factory overhead rate based on direct labor hours. For the month of October, Avery's budgeted overhead was $300,000 based on a budgeted volume of 100,000 direct labor hours. Actual overhead amounted to $325,000 with actual direct labor hours totaling 110,000. How much was the overapplied or underapplied overhead?

   a. $30,000 overapplied.
   b. $30,000 underapplied.
   c. $ 5,000 overapplied.
   d. $ 5,000 underapplied.

1N83#43. Regan Company operates its factory on a two-shift basis and pays a late-shift differential of 15%. Regan also pays a premium of 50% for overtime work. Since Regan manufactures only for stock, the cost system provides for uniform direct-labor hourly charges for production done without regard to shift worked or work done on an over-time basis. Overtime and late-shift differentials are included in Regan's factory overhead rate application. The May 1983 payroll for production workers is as follows:

| Wages at base direct-labor rates | $325,000 |
| Shift differentials              | 25,000   |
| Overtime premiums                | 10,000   |

For the month of May 1983, what amount of direct labor should Regan charge to work-in-process?

   a. $325,000
   b. $335,000
   c. $350,000
   d. $360,000

1N83#44. Worley Company has underapplied overhead of $45,000 for the year ended December 31, 1982. Before disposition of the underapplied overhead, selected December 31, 1982, balances from Worley's accounting records are as follows:

| Sales                                    | $1,200,000 |
| Cost of goods sold                       | 720,000    |
| Inventories:                             |           |
| Direct materials                         | 36,000    |
| Work-in-process                          | 54,000    |
| Finished goods                           | 90,000    |

Under Worley's cost accounting system, over or underapplied overhead is allocated to appropriate inventories and cost of goods sold based on year-end balances. In its 1982 income statement, Worley should report cost of goods sold of

   a. $682,500
   b. $684,000
   c. $756,000
   d. $757,500

1M83 Items 22 and 23 are based on the following information:

Summit Company provided the following inventory balances and manufacturing cost data for the month of January 1983:

<table>
<thead>
<tr>
<th>Inventories:</th>
<th>1/1/83</th>
<th>1/31/83</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$30,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Work-in-process</td>
<td>15,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>65,000</td>
<td>50,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Month of January 1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods manufactured</td>
</tr>
<tr>
<td>Factory overhead applied</td>
</tr>
<tr>
<td>Direct materials used</td>
</tr>
<tr>
<td>Actual factory overhead</td>
</tr>
</tbody>
</table>

Under Summit's cost system, any over or underapplied overhead is closed to the cost of goods sold account at the end of the calendar year.

22. What was the total amount of direct-material purchases during January 1983?

   a. $180,000
   b. $190,000
   c. $195,000
   d. $200,000

23. How much direct-labor cost was incurred during January 1983?

   a. $170,000
   b. $175,000
   c. $180,000
   d. $186,000

1M83 Items 26 through 28 are based on the following information:

Wayne Company had the following inventories at the beginning and end of March 1983:

<table>
<thead>
<tr>
<th>Inventories:</th>
<th>3/1/83</th>
<th>3/31/83</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$36,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Work-in-process</td>
<td>18,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>54,000</td>
<td>72,000</td>
</tr>
</tbody>
</table>

The following additional manufacturing cost data were available for the month of March 1983:

<table>
<thead>
<tr>
<th>Cost Data</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials purchased</td>
<td>$84,000</td>
</tr>
<tr>
<td>Direct-labor payroll</td>
<td>60,000</td>
</tr>
<tr>
<td>Direct-labor rate per hour</td>
<td>7.50</td>
</tr>
<tr>
<td>Factory overhead rate per direct-labor hour</td>
<td>10.00</td>
</tr>
</tbody>
</table>
26. During March 1983 prime cost added to production was
   a. $ 90,000
   b. $140,000
   c. $144,000
   d. $150,000

27. During March 1983 conversion cost added to production was
   a. $ 60,000
   b. $ 80,000
   c. $140,000
   d. $150,000

28. The cost of goods manufactured for March 1983 was
   a. $212,000
   b. $218,000
   c. $230,000
   d. $236,000

2N82

Items 31 and 32 are based on the following data:

Roja Corporation makes aluminum fasteners. Among Roja’s 1981 manufacturing costs were the following:

\[\begin{array}{ll}
\text{Wages and salaries} & \\
\text{Machine operators} & $ 80,000 \\
\text{Factory foremen} & 30,000 \\
\text{Machine mechanics} & 20,000 \\
\text{Materials and supplies} & \\
\text{Aluminum} & $400,000 \\
\text{Machine parts} & 18,000 \\
\text{Lubricants for machines} & 5,000
\end{array}\]

31. Direct labor amounted to
   a. $ 80,000
   b. $100,000
   c. $110,000
   d. $130,000

32. Direct materials amounted to
   a. $400,000
   b. $405,000
   c. $418,000
   d. $423,000

2N82

Items 37 and 38 are based on the following data:

Morton Company’s manufacturing costs for 1981 were as follows:

\[\begin{array}{ll}
\text{Direct materials} & $300,000 \\
\text{Direct labor} & 400,000 \\
\text{Factory overhead:} & \\
\text{Variable} & 80,000 \\
\text{Fixed} & 50,000
\end{array}\]

37. Prime cost totaled
   a. $300,000
   b. $380,000
   c. $700,000
   d. $830,000

38. Conversion cost totaled
   a. $400,000
   b. $480,000
   c. $530,000
   d. $830,000

1M82#21. Hartwell Company distributes the service department overhead costs directly to producing departments without allocation to the other service department. Information for the month of January 1982 is as follows:

\[\begin{array}{cc}
\text{Service departments} & \\
\text{Maintenance} & \text{Utilities} \\
\hline
\text{Overhead costs incurred} & $18,700 & \text{9,000} \\
\text{Service provided to:} & \\
\text{Maintenance department} & \text{—} & 10\% \\
\text{Utilities department} & 20\% & \text{—} \\
\text{Produceing department A} & 40\% & 30\% \\
\text{Produceing department B} & 40\% & 60\% \\
\text{Total} & 100\% & 100\% \\
\end{array}\]

The amount of utilities department costs distributed to producing department B for January 1982 should be
   a. $3,600
   b. $4,500
   c. $5,400
   d. $6,000

B. Process and Job Order Costing

2M85#12. During March 1985 Bly Co.’s Department Y equivalent unit product costs, computed under the weighted-average method, were as follows:

\[\begin{array}{ll}
\text{Materials} & \text{1} \\
\text{Conversion} & \text{3} \\
\text{Transferred-in} & \text{5}
\end{array}\]

Materials are introduced at the end of the process in Department Y. There were 4,000 units (40% complete as to conversion cost) in work-in-process at March 31, 1985. The total costs assigned to the March 31, 1985, work-in-process inventory should be
   a. $36,000
   b. $28,800
   c. $27,200
   d. $24,800
Selected Questions

2M85

Items 15 and 16 are based on the following data:

Kaden Corp. has two divisions — Ace and Bow. Ace has a job order cost system and manufactures machinery on special order for unrelated customers. Bow has a process cost system and manufactures Product Zee which is sold to Ace as well as to unrelated companies. Ace's work-in-process account at April 30, 1985, comprised the following:

<table>
<thead>
<tr>
<th>Items</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, April 1</td>
<td>$24,000</td>
</tr>
<tr>
<td>Direct materials (including transferred-in cost)</td>
<td>$80,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>$60,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>$54,000</td>
</tr>
<tr>
<td>Transferred to finished goods</td>
<td>(200,000)</td>
</tr>
</tbody>
</table>

Ace applies factory overhead at 90% of direct labor cost. Job No. 125, which was the only job in process at April 30, has been charged with factory overhead of $4,500. Bow's cost to manufacture Product Zee is $3.00 per unit, which is sold to Ace for $5.00 per unit and to unrelated customers for $6.00 per unit.

15. Direct materials (including transferred-in cost) charged to Job No. 125 amounted to
   a. $5,000
   b. $8,500
   c. $13,500
   d. $18,000

1N83#45. Department A is the first stage of Mann Company's production cycle. The following information is available for conversion costs for the month of April 1983:

<table>
<thead>
<tr>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process, beginning (60% complete)</td>
</tr>
<tr>
<td>Started in April</td>
</tr>
<tr>
<td>Completed in April and transferred to department B</td>
</tr>
<tr>
<td>Work-in-process, ending (40% complete)</td>
</tr>
</tbody>
</table>

Using the FIFO method, the equivalent units for the conversion cost calculation are
   a. 320,000
   b. 324,000
   c. 336,000
   d. 360,000

1N83#46. Barnett Company adds materials at the beginning of the process in department M. Conversion costs were 75% complete as to the 8,000 units in work-in-process at May 1, 1983, and 50% complete as to the 6,000 units in work-in-process at May 31. During May 12,000 units were completed and transferred to the next department. An analysis of the costs relating to work-in-process at May 1 and to production activity for May is as follows:

<table>
<thead>
<tr>
<th>Costs</th>
<th>Materials</th>
<th>Conversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process, 5/1</td>
<td>$9,600</td>
<td>$4,800</td>
</tr>
<tr>
<td>Costs added in May</td>
<td>15,600</td>
<td>14,400</td>
</tr>
</tbody>
</table>

Using the weighted-average method, the total cost per equivalent unit for May was
   a. $2.47
   b. $2.50
   c. $2.68
   d. $3.16

1M83#21. Walden Company has a process cost system using the FIFO cost flow method. All materials are introduced at the beginning of the process in department One. The following information is available for the month of January 1983:

<table>
<thead>
<tr>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process, 1/1/83 (40% complete as to conversion costs)</td>
</tr>
<tr>
<td>Started in January</td>
</tr>
<tr>
<td>Transferred to department Two during January 1983</td>
</tr>
<tr>
<td>Work-in-process, 1/31/83 (25% complete as to conversion costs)</td>
</tr>
</tbody>
</table>

What are the equivalent units of production for the month of January 1983?

<table>
<thead>
<tr>
<th>Materials</th>
<th>Conversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 2,500</td>
<td>2,200</td>
</tr>
<tr>
<td>b. 2,500</td>
<td>1,900</td>
</tr>
<tr>
<td>c. 2,000</td>
<td>2,200</td>
</tr>
<tr>
<td>d. 2,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>

1M83#24. Elliott Company manufactures tools to customer specifications. The following data pertain to Job 1501 for February 1983:

<table>
<thead>
<tr>
<th>Costs</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials used</td>
<td>$4,200</td>
</tr>
<tr>
<td>Direct-labor hours worked</td>
<td>300</td>
</tr>
<tr>
<td>Direct-labor rate per hour</td>
<td>$8.00</td>
</tr>
<tr>
<td>Machine hours used</td>
<td>200</td>
</tr>
<tr>
<td>Applied factory overhead rate per machine hour</td>
<td>$15.00</td>
</tr>
</tbody>
</table>

What is the total manufacturing cost recorded on Job 1501 for February 1983?
   a. $8,800
   b. $9,600
   c. $10,500
   d. $11,100
Accounting Practice

1M83#32. Blackwood uses a job order cost system and applies factory overhead to production orders on the basis of direct-labor cost. The overhead rates for 1982 are 200% for department A and 50% for department B. Job 123, started and completed during 1982, was charged with the following costs:

<table>
<thead>
<tr>
<th>Department</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$25,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>?</td>
<td>30,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>40,000</td>
<td>?</td>
</tr>
</tbody>
</table>

The total manufacturing costs associated with Job 123 should be

a. $135,000
b. $180,000
c. $195,000
d. $240,000

1N82

Items 22 and 23 are based on the following information:

Hamilton Company uses job order costing. Factory overhead is applied to production at a predetermined rate of 150% of direct-labor cost. Any over or under-applied factory overhead is closed to the cost of goods sold account at the end of each month. Additional information is available as follows:

- Job 101 was the only job in process at January 31, 1982, with accumulated costs as follows:
  
  | Direct materials | $4,000 |
  | Direct labor     | 2,000  |
  | Applied factory overhead | 3,000 |
  | Total           | $9,000 |

- Jobs 102, 103, and 104 were started during February.
- Direct materials requisitions for February totaled $26,000.
- Direct-labor cost of $20,000 was incurred for February.
- Actual factory overhead was $32,000 for February.
- The only job still in process at February 28, 1982, was Job 104, with costs of $2,800 for direct materials and $1,800 for direct labor.

22. The cost of goods manufactured for February 1982 was

a. $77,700
b. $78,000
c. $79,700
d. $85,000

23. Over or underapplied factory overhead should be closed to the cost of goods sold account at February 28, 1982, in the amount of

a. $700 overapplied.
b. $1,000 overapplied.
c. $1,700 underapplied.
d. $2,000 underapplied.

1N82

Items 32 and 33 are based on the following information:

Bronson Company had 6,000 units in work-in-process at January 1, 1982, which were 60% complete as to conversion costs. During January 20,000 units were completed. At January 31, 1982, 8,000 units remained in work-in-process which were 40% complete as to conversion costs. Materials are added at the beginning of the process.

32. Using the weighted-average method, the equivalent units for January for conversion costs were

a. 19,600
b. 22,400
c. 23,200
d. 25,600

33. How many units were started during January?

a. 18,000
b. 19,600
c. 20,000
d. 22,000

1M82#23. Worrell Corporation has a job order cost system. The following debits (credits) appeared in the general ledger account work-in-process for the month of March 1982:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 1, balance</td>
<td>$12,000</td>
<td></td>
</tr>
<tr>
<td>March 31, direct materials</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>March 31, direct labor</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>March 31, factory overhead</td>
<td>27,000</td>
<td></td>
</tr>
<tr>
<td>March 31, to finished goods</td>
<td>(100,000)</td>
<td></td>
</tr>
</tbody>
</table>

Worrell applies overhead to production at a predetermined rate of 90% based on the direct-labor cost. Job No. 232, the only job still in process at the end of March 1982, has been charged with factory overhead of $2,250. What was the amount of direct materials charged to Job No. 232?

a. $2,250
b. $2,500
c. $4,250
d. $9,000
Selected Questions

1M82#25. Information for the month of January 1982 concerning department A, the first stage of Ogden Corporation's production cycle, is as follows:

<table>
<thead>
<tr>
<th>Materials</th>
<th>Conversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process, beginning</td>
<td>$8,000</td>
</tr>
<tr>
<td>Current costs</td>
<td>40,000</td>
</tr>
<tr>
<td>Total costs</td>
<td>$48,000</td>
</tr>
</tbody>
</table>

Equivalent units using weighted-average method: 100,000 complete units, 95,000 in-process units.

Average unit costs: $0.48 materials, $0.40 conversion.

Goods completed: 90,000 units.

Work-in-process, end: 10,000 units.

Materials are added at the beginning of the process. The ending work-in-process is 50% complete as to conversion costs. How would the total costs accounted for be distributed, using the weighted-average method?

1M81#21. Materials are added at the start of the process in Cedar Company's blending department, the first stage of the production cycle. The following information is available for the month of July 1981:

- Work-in-process, July 1 (60% complete as to conversion costs): 60,000 units
- Started in July: 150,000 units
- Transferred to the next department: 110,000 units
- Lost in production: 30,000 units
- Work-in-process, July 31 (50% complete as to conversion costs): 70,000 units

Under Cedar's cost accounting system, the costs incurred on the lost units are absorbed by the remaining good units. Using the weighted-average method, what are the equivalent units for the materials unit cost calculation?

a. 120,000
b. 145,000
c. 180,000
d. 210,000

1M81#32. Information concerning department A of Stover Company for the month of June is as follows:

<table>
<thead>
<tr>
<th>Materials</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process, beginning</td>
<td>17,000</td>
</tr>
<tr>
<td>Started in June</td>
<td>82,000</td>
</tr>
<tr>
<td>Units completed</td>
<td>85,000</td>
</tr>
<tr>
<td>Work-in-process, end</td>
<td>14,000</td>
</tr>
</tbody>
</table>

Materials are added at the beginning of the process. Using the weighted-average method, the cost per equivalent unit for materials costs is

a. $0.83
b. $0.85
c. $0.97
d. $1.01

1M81#38. Tillman Corporation uses a job-order cost system and has two production departments, M and A. Budgeted manufacturing costs for 1980 are as follows:

<table>
<thead>
<tr>
<th>Department</th>
<th>Department</th>
</tr>
</thead>
<tbody>
<tr>
<td>M</td>
<td>A</td>
</tr>
<tr>
<td>Direct materials</td>
<td>$700,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>200,000</td>
</tr>
<tr>
<td>Manufacturing overhead</td>
<td>600,000</td>
</tr>
</tbody>
</table>

Materials are added at the beginning of the process. The 12,000 units of work-in-process at March 31, 1982, were 80% complete as to conversion costs. The work-in-process at March 1, 1982, was 60% complete as to conversion costs. Using the FIFO method, the equivalent units for March conversion costs were

a. 55,200
b. 57,000
c. 60,600
d. 63,600
The actual material and labor costs charged to Job No. 432 during 1980 were as follows:

<table>
<thead>
<tr>
<th>Cost Type</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct material</td>
<td>$25,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td></td>
</tr>
<tr>
<td>Department M</td>
<td>$8,000</td>
</tr>
<tr>
<td>Department A</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

Tillman applies manufacturing overhead to production orders on the basis of direct-labor cost using departmental rates predetermined at the beginning of the year based on the annual budget. The total manufacturing cost associated with Job No. 432 for 1980 should be

- a. $50,000
- b. $55,000
- c. $65,000
- d. $75,000

C. Standard Costing

2N84

Items 16 and 17 are based on the following data:

The following information pertains to Nell Company's production of one unit of its manufactured product during the month of June:

- Standard quantity of materials: 5 lbs.
- Standard cost per lb.: $.20
- Standard direct labor hours: .4
- Standard wage rate per hour: $7.00
- Materials purchased: 100,000 lbs.
- Cost of materials purchased: $.17 per lb.
- Materials consumed for manufacture of 10,000 units: 60,000 lbs.
- Actual direct labor hours required for 10,000 units: 3,900
- Actual direct labor cost per hour: $7.20

The materials price variance is recognized when materials are purchased.

16. Nell's materials price variance for June was
   - a. $3,000 favorable.
   - b. $3,000 unfavorable.
   - c. $2,000 favorable.
   - d. $2,000 unfavorable.

17. Nell's labor efficiency variance for June was
   - a. $780 favorable.
   - b. $780 unfavorable.
   - c. $700 favorable.
   - d. $700 unfavorable

1N83#47. Geyer Company uses a standard cost system. For the month of April 1983, total overhead is budgeted at $80,000 based on the normal capacity of 20,000 direct-labor hours. At standard each unit of fin-

ished product requires 2 direct-labor hours. The following data are available for the April 1983 production activity:

- Equivalent units of product: 9,500
- Direct-labor hours worked: 19,500
- Actual total overhead incurred: $79,500

What amount should Geyer credit to the applied factory overhead account for the month of April 1983?

   - a. $76,000
   - b. $78,000
   - c. $79,500
   - d. $80,000

1N83#48. Information on Cox Company's direct-material costs for the month of January 1983 was as follows:

- Actual quantity purchased: 18,000
- Actual unit purchase price: $3.60
- Materials purchase price variance—unfavorable (based on purchases): $3,600
- Standard quantity allowed for actual production: 16,000
- Actual quantity used: 15,000

For January 1983 there was a favorable direct-material usage variance of

   - a. $3,360
   - b. $3,375
   - c. $3,400
   - d. $3,800

1N83#49. Harper Company uses a standard cost system. Data relating to direct labor for the month of August 1983 is as follows:

- Direct-labor efficiency variance—favorable: $5,250
- Standard direct-labor rate: $7.00
- Actual direct-labor rate: $7.50
- Standard hours allowed for actual production: 9,000

What are the actual hours worked for the month of August 1983?

   - a. 9,750
   - b. 8,400
   - c. 8,300
   - d. 8,250

1N83#39. Universal Company uses a standard cost system and prepared the following budget at normal capacity for the month of January 1983:

<table>
<thead>
<tr>
<th>Cost Type</th>
<th>Budgeted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct-labor hours</td>
<td>24,000</td>
</tr>
<tr>
<td>Variable factory overhead</td>
<td>$48,000</td>
</tr>
<tr>
<td>Fixed factory overhead</td>
<td>$108,000</td>
</tr>
<tr>
<td>Total factory overhead per hour</td>
<td>$7,650</td>
</tr>
</tbody>
</table>

AP-80
Actual data for January 1983 were as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct-labor hours worked</td>
<td>22,000</td>
</tr>
<tr>
<td>Total factory overhead</td>
<td>$147,000</td>
</tr>
<tr>
<td>Standard direct-labor hours allowed</td>
<td>21,000</td>
</tr>
</tbody>
</table>

Using the two-way analysis of overhead variances, what is the budget (controllable) variance for January 1983?

a. $3,000 favorable.
b. $5,000 favorable.
c. $9,000 favorable.
d. $10,500 unfavorable.

2N82#22. The following information pertains to Bates Company’s direct labor for March 1982:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard direct-labor hours</td>
<td>21,000</td>
</tr>
<tr>
<td>Actual direct-labor hours</td>
<td>20,000</td>
</tr>
<tr>
<td>Favorable direct-labor rate variance</td>
<td>$8,400</td>
</tr>
<tr>
<td>Standard direct-labor rate per hour</td>
<td>$6.30</td>
</tr>
</tbody>
</table>

What was Bates’ total actual direct labor cost for March 1982?

a. $117,600
b. $118,000
c. $134,000
d. $134,400

2N82#24. Perkins Company, which has a standard cost-system, had 500 units of raw material X in its inventory at June 1, 1982, purchased in May for $1.20 per unit and carried at a standard cost of $1.00. The following information pertains to raw material X for the month of June 1982:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual number of units purchased</td>
<td>1,400</td>
</tr>
<tr>
<td>Actual number of units used</td>
<td>1,500</td>
</tr>
<tr>
<td>Standard number of units allowed for actual production</td>
<td>1,300</td>
</tr>
<tr>
<td>Standard cost per unit</td>
<td>$1.00</td>
</tr>
<tr>
<td>Actual cost per unit</td>
<td>$1.10</td>
</tr>
</tbody>
</table>

The unfavorable materials purchase price variance for raw material X for June was

a. $0
b. $130
c. $140
d. $150

2N82#36. Cannon Cannery, Inc., estimated its factory overhead at $510,000 for 1981, based on a normal capacity of 100,000 direct-labor hours. Standard direct-labor hours for the year totaled 105,000, while the factory overhead control account at the end of the year showed a balance of $540,000. How much was the underapplied factory overhead for 1981?

a. $0
b. $4,500
c. $27,000
d. $30,000

1M82#22. Martin Company uses a two-way analysis of overhead variances. Selected data for the April 1982 production activity are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual variable factory overhead incurred</td>
<td>$196,000</td>
</tr>
<tr>
<td>Variable factory overhead rate per direct-labor hour</td>
<td>$6.00</td>
</tr>
<tr>
<td>Standard direct-labor hours allowed</td>
<td>33,000</td>
</tr>
<tr>
<td>Actual direct-labor hours</td>
<td>32,000</td>
</tr>
</tbody>
</table>

Assuming that budgeted fixed overhead costs are equal to actual fixed costs, the budget (controllable) variance for April 1982 is

a. $2,000 favorable.
b. $4,000 unfavorable.
c. $4,000 favorable.
d. $6,000 favorable.

1M82#25. Information on Hanley’s direct-labor costs for the month of January 1982 is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual direct-labor rate</td>
<td>$7.50</td>
</tr>
<tr>
<td>Standard direct-labor hours allowed</td>
<td>11,000</td>
</tr>
<tr>
<td>Actual direct-labor hours</td>
<td>10,000</td>
</tr>
<tr>
<td>Direct-labor rate variance—favorable</td>
<td>$5,500</td>
</tr>
</tbody>
</table>

What was the standard direct-labor rate in effect for the month of January 1982?

a. $6.95
b. $7.00
c. $8.00
d. $8.05

1M82#31. Buckler Company manufactures desks with vinyl tops. The standard material cost for the vinyl used per Model S desk is $27.00 based on twelve square feet of vinyl at a cost of $2.25 per square foot. A production run of 1,000 desks in March 1982 resulted in usage of 12,600 square feet of vinyl at a cost of $2.00 per square foot, a total cost of $25,200. The usage variance resulting from the above production run was

a. $1,200 unfavorable.
b. $1,350 unfavorable.
c. $1,800 favorable.
d. $3,150 favorable.

1N81#24. Information on Townsend Company’s direct-labor costs for May 1981 is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard direct-labor rate</td>
<td>$6.00</td>
</tr>
<tr>
<td>Actual direct-labor rate</td>
<td>$5.80</td>
</tr>
<tr>
<td>Standard direct-labor hours</td>
<td>20,000</td>
</tr>
<tr>
<td>Actual direct-labor hours</td>
<td>21,000</td>
</tr>
<tr>
<td>Direct-labor rate variance—favorable</td>
<td>$4,200</td>
</tr>
</tbody>
</table>
What is Townsend’s total direct-labor payroll for May 1981?

a. $116,000
b. $117,600
c. $120,000
d. $121,800

1N81#26. Throop Company had budgeted 50,000 units of output using 50,000 units of raw materials at a total material cost of $100,000. Actual output was 50,000 units of product requiring 45,000 units of raw materials at a cost of $2.10 per unit. The direct-material price variance and usage variance were:

<table>
<thead>
<tr>
<th>Price</th>
<th>Usage</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $ 4,500</td>
<td>$10,000 favorable</td>
</tr>
<tr>
<td>b. $ 5,000</td>
<td>$10,500 unfavorable</td>
</tr>
<tr>
<td>c. $ 5,000</td>
<td>$10,000 favorable</td>
</tr>
<tr>
<td>d. $10,000</td>
<td>$ 4,500 unfavorable</td>
</tr>
</tbody>
</table>

1N81#27. Union Company uses a standard cost accounting system. The following overhead costs and production data are available for August 1981:

Standard fixed overhead rate per direct-labor hour $1.00
Standard variable overhead rate per direct-labor hour $4.00
Budgeted monthly direct-labor hours 40,000
Actual direct-labor hours worked 39,500
Std. direct-labor hours allowed for actual production 39,000
Overall overhead variance — favorable $2,000

The applied factory overhead for August 1981 should be:

a. $195,000
b. $197,000
c. $197,500
d. $199,500

1M81#26. Dickey Company had total underapplied overhead of $15,000. Additional information is as follows:

Variable Overhead:
Applied based on standard direct-labor hours allowed $42,000
Budgeted based on standard direct-labor hours 38,000

Fixed Overhead:
Applied based on standard direct-labor hours allowed 30,000
Budgeted based on standard direct-labor hours 27,000

What is the actual total overhead?

a. $50,000
b. $57,000
c. $80,000
d. $87,000

1M81#27. Information on Barber Company’s direct-labor costs for the month of January 1981 is as follows:

- Actual direct-labor hours 34,500
- Standard direct-labor hours 35,000
- Total direct-labor payroll $241,500
- Direct-labor efficiency variance — favorable $3,200

What is Barber’s direct-labor rate variance?

a. $17,250 unfavorable
b. $20,700 unfavorable
c. $21,000 unfavorable
d. $21,000 unfavorable

1M81#28. During March 1981 Younger Company’s direct-material costs for the manufacture of product T were as follows:

- Actual unit purchase price $6.50
- Standard quantity allowed for actual production 2,100
- Quantity purchased and used for actual production 2,300
- Standard unit price $6.25

Younger’s material usage variance for March 1981 was:

a. $1,250 unfavorable
b. $1,250 favorable
c. $1,300 unfavorable
d. $1,300 favorable

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

1N83 Items 51 and 52 are based on the following information:

Grafton Company produces joint products A and B in department One from a process which also yields by-product W. Product A and by-product W are sold after separation, but product B must be further processed in department Two before it can be sold. The cost assigned to the by-products is its market value less $0.40 per pound for delivery expense (net realizable value method). Information relating to a batch produced in July 1983 is as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>Production (in pounds)</th>
<th>Sales price per pound</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>2,000</td>
<td>$4.50</td>
</tr>
<tr>
<td>B</td>
<td>4,000</td>
<td>9.00</td>
</tr>
<tr>
<td>W</td>
<td>500</td>
<td>1.50</td>
</tr>
</tbody>
</table>

Joint cost in department One $18,000
Product B additional process cost in department Two $10,000
Selected Questions

51. For joint cost allocation purposes, what is the net realizable value at the split-off point of product B?
   a. $46,000
   b. $45,000
   c. $36,000
   d. $26,000

52. How much of the joint cost incurred in department One should be allocated to the joint products?
   a. $17,250
   b. $17,450
   c. $17,800
   d. $18,550

1M83/54. During March 1983 Hart Company incurred the following costs on Job 109 for the manufacture of 200 motors:

Original cost accumulation:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$ 660</td>
</tr>
<tr>
<td>Direct labor</td>
<td>800</td>
</tr>
<tr>
<td>Factory overhead (150% of labor)</td>
<td>1,200</td>
</tr>
<tr>
<td>Total</td>
<td>$2,660</td>
</tr>
</tbody>
</table>

Direct costs of reworking 10 units:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$ 100</td>
</tr>
<tr>
<td>Direct labor</td>
<td>160</td>
</tr>
<tr>
<td>Total</td>
<td>$ 260</td>
</tr>
</tbody>
</table>

The rework costs were attributable to exacting specifications of Job 109 and the full rework costs were charged to this specific job. The cost per finished unit of Job 109 was

a. $15.80
b. $14.60
c. $14.00
d. $13.30

1M83/30. Barkley Company adds materials at the beginning of the process in department M. Data concerning the materials used in March 1983 production are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process at March 1</td>
<td>16,000</td>
</tr>
<tr>
<td>Started during March</td>
<td>34,000</td>
</tr>
<tr>
<td>Completed and transferred to next department during March</td>
<td>36,000</td>
</tr>
<tr>
<td>Normal spoilage incurred</td>
<td>4,000</td>
</tr>
<tr>
<td>Work-in-process at March 31</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Using the weighted-average method, the equivalent units for the materials unit cost calculation are

a. 30,000
b. 34,000
c. 40,000
d. 46,000

1M83

Items 35 and 36 are based on the following information:

Warfield Corporation manufactures products C, D, and E from a joint process. Joint costs are allocated on the basis of relative-sales-value at split-off. Additional information is as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units produced</td>
<td>6,000</td>
<td>4,000</td>
<td>2,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Joint costs</td>
<td>$ 72,000</td>
<td>?</td>
<td>?</td>
<td>$120,000</td>
</tr>
<tr>
<td>Sales value at split-off</td>
<td>?</td>
<td>?</td>
<td>$30,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Additional costs if processed further</td>
<td>$14,000</td>
<td>$10,000</td>
<td>$6,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Sales value if processed further</td>
<td>$140,000</td>
<td>$60,000</td>
<td>$40,000</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

35. How much of the joint costs should Warfield allocate to product D?

   a. $24,000
   b. $28,800
   c. $30,000
   d. $32,000

36. Assuming that the 2,000 units of product E were processed further and sold for $40,000, what was Warfield's gross profit on the sale?

   a. $ 4,000
   b. $14,000
   c. $16,000
   d. $22,000

1M83/37. Simpson Company manufactures electric drills to the exacting specifications of various customers. During April 1983, Job 403 for the production of 1,100 drills was completed at the following costs per unit:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$10</td>
</tr>
<tr>
<td>Direct labor</td>
<td>8</td>
</tr>
<tr>
<td>Applied factory overhead</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>$30</td>
</tr>
</tbody>
</table>

Final inspection of Job 403 disclosed 50 defective units and 100 spoiled units. The defective drills were reworked at a total cost of $500 and the spoiled drills were sold to a jobber for $1,500. What would be the unit cost of the good units produced on Job 403?

   a. $33
   b. $32
   c. $30
   d. $29
Crowley Company produces joint products A and B from a process which also yields a by-product, Y. The by-product requires additional processing before it can be sold. The cost assigned to the by-product is its market value less additional costs incurred after split-off (net realizable value method). Information concerning a batch produced in January 1983 at a joint cost of $40,000 is as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>Units produced</th>
<th>Market value</th>
<th>Costs after split-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>800</td>
<td>$44,000</td>
<td>$4,500</td>
</tr>
<tr>
<td>B</td>
<td>700</td>
<td>32,000</td>
<td>3,500</td>
</tr>
<tr>
<td>Y</td>
<td>500</td>
<td>4,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>

How much of the joint cost should be allocated to the joint products?

a. $35,000  
b. $36,000  
c. $37,000  
d. $39,000

1M83#38.

Items 28 and 29 are based on the following information:

Harper Company's Job 501 for the manufacture of 2,200 coats was completed during August 1982 at the following unit costs:

- Direct materials: $20
- Direct labor: 18
- Factory overhead (includes an allowance of $1 for spoiled work): 18
  
Final inspection of Job 501 disclosed 200 spoiled coats which were sold to a jobber for $6,000.

28. Assume that spoilage loss is charged to all production during August 1982. What would be the unit cost of the good coats produced on Job 501?

a. $53.00  
b. $55.00  
c. $56.00  
d. $58.60

29. Assume, instead, that the spoilage loss is attributable to exacting specifications of Job 501 and is charged to this specific job. What would be the unit cost of the good coats produced on Job 501?

a. $55.00  
b. $57.50  
c. $58.60  
d. $61.60

2N82#26. Pendall Company manufactures products Dee and Eff from a joint process. Product Dee has been allocated $2,500 of total joint costs of $20,000 for the 1,000 units produced. Dee can be sold at the split-off point for $3 per unit, or it can be processed further with additional costs of $1,000 and sold for $5 per unit. If Dee is processed further and sold, the result would be

a. A break-even situation.  
b. An additional gain of $1,000 from further processing.  
c. An overall loss of $1,000.  
d. An additional gain of $2,000 from further processing.

2N82

Items 39 and 40 are based on the following data:

Earl Corporation manufactures a product that gives rise to a by-product called "Zafa." The only costs associated with Zafa are selling costs of $1 for each unit sold. Earl accounts for Zafa sales by deducting its separable costs from such sales, and then deducting this net amount from cost of sales of the major product. In 1981, 1,000 units of Zafa were sold at $4 each.

39. If Earl changes its method of accounting for Zafa sales by showing the net amount as additional sales revenue, then Earl's gross margin would

a. Be unaffected.  
b. Increase by $3,000.  
c. Decrease by $3,000.  
d. Increase by $4,000.

40. If Earl changes its method of accounting for Zafa sales by showing the net amount as "Other Income," then Earl's gross margin would

a. Be unaffected.  
b. Increase by $3,000.  
c. Decrease by $3,000.  
d. Decrease by $4,000.

2N82#25. Brill Company manufactures products Y and Z from a joint process. Sales value at split-off was $100,000 for 6,000 units of Y and $50,000 for 2,000 units of Z. The portion of total joint costs properly allocated to Y was $60,000, using the relative-sales-value at split-off approach. How much were the total joint costs?

a. $ 80,000  
b. $ 85,000  
c. $ 90,000  
d. $120,000

1M82#27. Under Heller Company's job order cost system, estimated costs of defective work (considered normal in the manufacturing process) are included in
Selected Questions

the predetermined factory overhead rate. During March 1982, Job No. 210 for 2,000 handsaws was completed at the following costs per unit:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$ 5</td>
</tr>
<tr>
<td>Direct labor</td>
<td>4</td>
</tr>
<tr>
<td>Factory overhead (applied at 150% of direct-labor cost)</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$15</strong></td>
</tr>
</tbody>
</table>

Final inspection of Job No. 210 disclosed 100 defective saws which were reworked at a cost of $2 per unit for direct labor, plus overhead at the predetermined rate. The defective units on Job No. 210 fall within the normal range. What is the total rework cost and to what account should it be charged?

<table>
<thead>
<tr>
<th>Rework cost</th>
<th>Account charged</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $200</td>
<td>Work-in-process</td>
</tr>
<tr>
<td>b. $200</td>
<td>Factory overhead control</td>
</tr>
<tr>
<td>c. $500</td>
<td>Work-in-process</td>
</tr>
<tr>
<td>d. $500</td>
<td>Factory overhead control</td>
</tr>
</tbody>
</table>

Additional information for the June 1981 production activity is as follows:

<table>
<thead>
<tr>
<th>Products</th>
<th>F</th>
<th>G</th>
<th>W</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units produced</td>
<td>50,000</td>
<td>40,000</td>
<td>10,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Joint costs</td>
<td>?</td>
<td>?</td>
<td>?</td>
<td>$450,000</td>
</tr>
<tr>
<td>Sales value at split-off</td>
<td>$420,000</td>
<td>$270,000</td>
<td>$60,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Additional costs if processed further</td>
<td>$88,000</td>
<td>$30,000</td>
<td>$12,000</td>
<td>$130,000</td>
</tr>
<tr>
<td>Sales value if processed further</td>
<td>$538,000</td>
<td>$320,000</td>
<td>$78,000</td>
<td>$936,000</td>
</tr>
</tbody>
</table>

Assuming that the 10,000 units of W were processed further and sold for $78,000, what was Ashwood's gross profit on this sale?

- a. $21,000
- b. $28,500
- c. $30,000
- d. $66,000

1M82#29. Tooker Company adds materials at the beginning of the process in department A. Information concerning the materials used in April 1982 production is as follows:

<table>
<thead>
<tr>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process at April 1</td>
</tr>
<tr>
<td>Started during April</td>
</tr>
<tr>
<td>Completed and transferred to next department during April</td>
</tr>
<tr>
<td>Normal spoilage incurred</td>
</tr>
<tr>
<td>Abnormal spoilage incurred</td>
</tr>
<tr>
<td>Work-in-process at April 30</td>
</tr>
</tbody>
</table>

Under Tooker’s cost accounting system, costs of normal spoilage are treated as a part of the costs of the good units produced. However, the costs of abnormal spoilage are charged to factory overhead. Using the weighted-average method, what are the equivalent units for the materials unit cost calculation for the month of April?

- a. 47,000
- b. 52,000
- c. 55,000
- d. 57,000

1M81#37. Stayman, Inc., manufactures products F, G, and H from a joint process. Additional information is as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units produced</td>
<td>8,000</td>
<td>4,000</td>
<td>2,000</td>
<td>14,000</td>
</tr>
<tr>
<td>Joint costs</td>
<td>?</td>
<td>?</td>
<td>$18,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Sales value at split-off</td>
<td>$120,000</td>
<td>?</td>
<td>?</td>
<td>$200,000</td>
</tr>
<tr>
<td>Additional costs if processed further</td>
<td>$14,000</td>
<td>$10,000</td>
<td>$6,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Sales value if processed further</td>
<td>$140,000</td>
<td>$60,000</td>
<td>$50,000</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

Assuming that joint product costs are allocated using the relative-sales-value at split-off approach, what were the joint costs allocated to product G?

- a. $28,800
- b. $30,000
- c. $34,000
- d. $51,000

1M81#22. Ashwood Company manufactures products F, G, and W from a joint process. Joint costs are allocated on the basis of relative-sales-value at split-off.
E. Absorption and Variable Costing

2N84

Items 19 and 20 are based on the following data:

Lina Co. produced 100,000 units of Product Zee during the month of June. Costs incurred during June were as follows:

<table>
<thead>
<tr>
<th>Costs</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials used</td>
<td>$100,000</td>
</tr>
<tr>
<td>Direct labor used</td>
<td>80,000</td>
</tr>
<tr>
<td>Variable manufacturing overhead</td>
<td>40,000</td>
</tr>
<tr>
<td>Fixed manufacturing overhead</td>
<td>50,000</td>
</tr>
<tr>
<td>Variable selling and general expenses</td>
<td>12,000</td>
</tr>
<tr>
<td>Fixed selling and general expenses</td>
<td>45,000</td>
</tr>
<tr>
<td>Total</td>
<td>$327,000</td>
</tr>
</tbody>
</table>

19. What was Product Zee's unit cost under absorption costing?
   a. $3.27
   b. $2.70
   c. $2.20
   d. $1.80

20. What was Product Zee's unit cost under variable (direct) costing?
   a. $2.82
   b. $2.70
   c. $2.32
   d. $2.20

2N83

Items 15 and 16 are based on the following data:

Bates Co. incurred the following costs:

<table>
<thead>
<tr>
<th>Costs</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials and direct labor</td>
<td>$600,000</td>
</tr>
<tr>
<td>Variable factory overhead</td>
<td>80,000</td>
</tr>
<tr>
<td>Straight-line depreciation:</td>
<td></td>
</tr>
<tr>
<td>Production machinery</td>
<td>70,000</td>
</tr>
<tr>
<td>Factory building</td>
<td>50,000</td>
</tr>
</tbody>
</table>

15. Under absorption costing, the inventoriable costs are
   a. $680,000
   b. $730,000
   c. $750,000
   d. $800,000

16. Under variable (direct) costing, the inventoriable costs are
   a. $600,000
   b. $680,000
   c. $720,000
   d. $750,000

1M83

Items 33 and 34 are based on the following information:

Gordon Company began its operations on January 1, 1982, and produces a single product that sells for $10 per unit. Gordon uses an actual (historical) cost system. In 1982, 100,000 units were produced and 80,000 units were sold. There was no work-in-process inventory at December 31, 1982.

Manufacturing costs and selling and administrative expenses for 1982 were as follows:

<table>
<thead>
<tr>
<th>Costs</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed costs</td>
<td></td>
</tr>
<tr>
<td>Raw materials</td>
<td>—</td>
</tr>
<tr>
<td>Direct labor</td>
<td>— $2.00 per unit produced</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>$120,000</td>
</tr>
<tr>
<td>Selling and administrative</td>
<td>70,000</td>
</tr>
<tr>
<td>Administrative</td>
<td>1.00 per unit sold</td>
</tr>
</tbody>
</table>

33. What would be Gordon's operating income for 1982 under the variable (direct) costing method?
   a. $114,000
   b. $210,000
   c. $234,000
   d. $330,000

34. What would be Gordon's finished goods inventory at December 31, 1982, under the absorption costing method?
   a. $80,000
   b. $104,000
   c. $110,000
   d. $124,000

1N82

Items 24 and 25 are based on the following information:

Selected information concerning the operations of Kern Company for the year ended December 31, 1981, is available as follows:

<table>
<thead>
<tr>
<th>Information</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units produced</td>
<td>10,000</td>
</tr>
<tr>
<td>Units sold</td>
<td>9,000</td>
</tr>
<tr>
<td>Direct materials used</td>
<td>$40,000</td>
</tr>
<tr>
<td>Direct labor incurred</td>
<td>$20,000</td>
</tr>
<tr>
<td>Fixed factory overhead</td>
<td>$25,000</td>
</tr>
<tr>
<td>Variable factory overhead</td>
<td>$12,000</td>
</tr>
<tr>
<td>Fixed selling and administrative expenses</td>
<td>$30,000</td>
</tr>
<tr>
<td>Variable selling and administrative expenses</td>
<td>$4,500</td>
</tr>
<tr>
<td>Finished goods inventory, January 1, 1981</td>
<td>None</td>
</tr>
</tbody>
</table>
There were no work-in-process inventories at the beginning and end of 1981.

24. What would be Kern's finished goods inventory cost at December 31, 1981, under the variable (direct) costing method?
   a. $7,200
   b. $7,650
   c. $8,000
   d. $9,700

25. Which costing method, absorption or variable costing, would show a higher operating income for 1981 and by what amount?

Costing method

<table>
<thead>
<tr>
<th>Methods</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Absorption</td>
<td>$2,500</td>
</tr>
<tr>
<td>b. Variable</td>
<td>$5,500</td>
</tr>
<tr>
<td>c. Absorption</td>
<td>$5,500</td>
</tr>
<tr>
<td>d. Variable</td>
<td>$5,500</td>
</tr>
</tbody>
</table>

2N82/#30. Keller Company, a manufacturer of rivets, uses absorption costing. Keller's 1981 manufacturing costs were as follows:

- Direct materials and direct labor: $800,000
- Depreciation of machines: 100,000
- Rent for factory building: 60,000
- Electricity to run machines: 35,000

How much of these costs should be inventoried?

<table>
<thead>
<tr>
<th>Methods</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $800,000</td>
<td></td>
</tr>
<tr>
<td>b. $835,000</td>
<td></td>
</tr>
<tr>
<td>c. $935,000</td>
<td></td>
</tr>
<tr>
<td>d. $995,000</td>
<td></td>
</tr>
</tbody>
</table>

1M82 Items 39 and 40 are based on the following information:

Information from Peterson Company's records for the year ended December 31, 1981, is available as follows:

- Net sales: $1,400,000
- Cost of goods manufactured:
  - Variable: $630,000
  - Fixed: $315,000
- Operating expenses:
  - Variable: $98,000
  - Fixed: $140,000
- Units manufactured: 70,000
- Units sold: 60,000
- Finished goods inventory, January 1, 1981: None

39. What would be Peterson's finished goods inventory cost at December 31, 1981, under the variable (direct) costing method?
   a. $ 90,000
   b. $104,000
   c. $105,000
   d. $135,000

40. Under the absorption costing method, Peterson's operating income for 1981 would be
   a. $217,000
   b. $307,000
   c. $352,000
   d. $374,500

1M81/#23. During January 1981 Gable, Inc., produced 10,000 units of product F with costs as follows:

- Direct materials: $40,000
- Direct labor: 22,000
- Variable overhead: 13,000
- Fixed overhead: 10,000

What is Gable's unit cost of product F for January 1981 calculated on the direct costing basis?

<table>
<thead>
<tr>
<th>Methods</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $6.20</td>
<td></td>
</tr>
<tr>
<td>b. $7.20</td>
<td></td>
</tr>
<tr>
<td>c. $7.50</td>
<td></td>
</tr>
<tr>
<td>d. $8.50</td>
<td></td>
</tr>
</tbody>
</table>

F. Budgeting and Flexible Budgeting

1N83/#41. Walman Company is budgeting sales of 42,000 units of product Y for March 1983. To make one unit of finished product, three pounds of raw material A are required. Actual beginning and desired ending inventories of raw material A and product Y are as follows:

- Raw material A: 100,000 pounds (3/31/83) 110,000 pounds (3/31/83)
- Product Y: 22,000 units (3/31/83) 24,000 units (3/31/83)

There is no work-in-process inventory for product Y at the beginning and end of March. For the month of March, how many pounds of raw material A is Walman planning to purchase?

<table>
<thead>
<tr>
<th>Methods</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 126,000</td>
<td></td>
</tr>
<tr>
<td>b. 132,000</td>
<td></td>
</tr>
<tr>
<td>c. 136,000</td>
<td></td>
</tr>
<tr>
<td>d. 142,000</td>
<td></td>
</tr>
</tbody>
</table>
1N83#55. In preparing its cash budget for July 1983, Reed Company made the following projections:

Sales
Gross profit (based on sales) $1,500,000
Decrease in inventories $ 70,000
Decrease in accounts payable for inventories $120,000

For July 1983 what were the estimated cash disbursements for inventories?
    a. $ 935,000
    b. $1,050,000
    c. $1,055,000
    d. $1,175,000

1N83#56. Fawcett Company uses a flexible budget system and prepared the following information for 1982:

<table>
<thead>
<tr>
<th>Normal capacity</th>
<th>Maximum capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent of capacity</td>
<td>80%</td>
</tr>
<tr>
<td>Direct-labor hours</td>
<td>32,000</td>
</tr>
<tr>
<td>Variable factory overhead</td>
<td>$ 64,000</td>
</tr>
<tr>
<td>Fixed factory overhead</td>
<td>$160,000</td>
</tr>
<tr>
<td>Total factory overhead rate per direct-labor hour</td>
<td>$7</td>
</tr>
</tbody>
</table>

Fawcett operated at 90% of capacity during 1982. The actual factory overhead for 1982 was $252,000. What was the budget (controllable) overhead variance for the year?
    a. $36,000 unfavorable.
    b. $20,000 unfavorable.
    c. $18,000 unfavorable.
    d. $0.

1N83#31. Lawton Company produces canned tomato soup and is budgeting sales of 250,000 units for the month of January 1983. Actual inventory units at January 1 and budgeted inventory units at January 31 are as follows:

<table>
<thead>
<tr>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual inventory at January 1: Work-in-process</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Budgeted inventory at January 31: Work-in-process (75% processed)</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

How many equivalent units of production is Lawton budgeting for January 1983?
    a. 235,000
    b. 247,000
    c. 251,000
    d. 253,000

1N82#21. Dean Company is preparing a flexible budget for 1982 and the following maximum capacity estimates for department M are available:

<table>
<thead>
<tr>
<th>At maximum capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct-labor hours</td>
</tr>
<tr>
<td>Variable factory overhead</td>
</tr>
<tr>
<td>Fixed factory overhead</td>
</tr>
</tbody>
</table>

Assume that Dean’s normal capacity is 80% of maximum capacity. What would be the total factory overhead rate, based on direct-labor hours, in a flexible budget at normal capacity?
    a. $6.00
    b. $6.50
    c. $7.50
    d. $8.13

1N82#27. Reid Company is budgeting sales of 100,000 units of product R for the month of September 1982. Production of one unit of product R requires two units of material A and three units of material B. Actual inventory units at September 1 and budgeted inventory units at September 30 are as follows:

<table>
<thead>
<tr>
<th>Actual inventory at September 1</th>
<th>Budgeted inventory at September 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product R</td>
<td>20,000</td>
</tr>
<tr>
<td>Material A</td>
<td>25,000</td>
</tr>
<tr>
<td>Material B</td>
<td>22,000</td>
</tr>
</tbody>
</table>

How many units of material B is Reid planning to purchase during September 1982?
    a. 328,000
    b. 302,000
    c. 298,000
    d. 272,000

1N82#30. Eriksen Company has budgeted its activity for October 1982 based on the following information:

- Sales are budgeted at $300,000. All sales are credit sales and a provision for doubtful accounts is made monthly at the rate of 3% sales.
- Merchandise inventory was $70,000 at September 30, 1982, and an increase of $10,000 is planned for the month.
- All merchandise is marked up to sell at invoice cost plus 50%.
- Estimated cash disbursements for selling and administrative expenses for the month are $40,000.
- Depreciation for the month is projected at $5,000.
Selected Questions

Eriksen is projecting operating income for October 1982 in the amount of
a. $96,000
b. $56,000
c. $55,000
d. $46,000

1N82#34. Brooks Company uses the following flexible budget formula for the 1982 annual maintenance cost in department T:

Total cost = $7,200 + $0.60 per machine hour

The July 1982 operating budget is based upon 20,000 hours of planned machine time. Maintenance cost included in this flexible budget is
a. $11,400
b. $12,000
c. $12,600
d. $19,200

1N82#36. In preparing its budget for July 1982, Robinson Company has the following accounts receivable information available:

Accounts receivable at June 30, 1982 $350,000
Estimated credit sales for July 400,000
Estimated collections in July for credit sales in July and prior months 320,000
Estimated write-offs in July for uncollectible credit sales 16,000
Estimated provision for doubtful accounts for credit sales in July 12,000

What is the projected balance of accounts receivable at July 31, 1982?

a. $402,000
b. $414,000
c. $426,000
d. $430,000

1N81#25. Jackson, Inc., is preparing a flexible budget for 1981 and requires a breakdown of the cost of steam used in its factory into the fixed and variable elements. The following data on the cost of steam used and direct-labor hours worked are available for the last six months of 1980:

<table>
<thead>
<tr>
<th>Month</th>
<th>Cost of steam</th>
<th>Direct-labor hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>July</td>
<td>$15,850</td>
<td>3,000</td>
</tr>
<tr>
<td>August</td>
<td>13,400</td>
<td>2,050</td>
</tr>
<tr>
<td>September</td>
<td>16,370</td>
<td>2,900</td>
</tr>
<tr>
<td>October</td>
<td>19,800</td>
<td>3,650</td>
</tr>
<tr>
<td>November</td>
<td>17,600</td>
<td>2,670</td>
</tr>
<tr>
<td>December</td>
<td>18,500</td>
<td>2,650</td>
</tr>
<tr>
<td>Total</td>
<td>$101,520</td>
<td>16,920</td>
</tr>
</tbody>
</table>

Assuming that Jackson uses the high-low points method of analysis, the estimated variable cost of steam per direct-labor hour should be
a. $4.00
b. $5.42
c. $5.82
d. $6.00

2N82#28. Betz Company's sales budget shows the following projections for the year ending December 31, 1983:

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>60,000</td>
</tr>
<tr>
<td>Second</td>
<td>80,000</td>
</tr>
<tr>
<td>Third</td>
<td>45,000</td>
</tr>
<tr>
<td>Fourth</td>
<td>55,000</td>
</tr>
<tr>
<td>Total</td>
<td>240,000</td>
</tr>
</tbody>
</table>

Inventory at December 31, 1982, was budgeted at 18,000 units. The quantity of finished goods inventory at the end of each quarter is equal 30% of the next quarter's budgeted sales of units. How much should the production budget show for units to be produced during the first quarter?

a. 24,000
b. 48,000
c. 66,000
d. 72,000

2N82#23. Pratt Company is preparing its cash budget for the month ending November 30, 1982. The following information pertains to Pratt's past collection experience from its credit sales:

Current month's sales 12%
Prior month's sales 75%
Sales two months prior to current month 6%
Sales three months prior to current month 4%
Cash discounts (2/30, net 90) 2%
Doubtful accounts 1%

Credit sales:

November — estimated $200,000
October 180,000
September 160,000
August 190,000

How much is the estimated credit to accounts receivable as a result of collections expected during November?

a. $170,200
b. $174,200
c. $176,200
d. $180,200

AP-89
Accounting Practice

1N81#23. Sussex Company has budgeted its operations for February 1981. No change in inventory level during the month is planned. Selected data from estimated amounts are as follows:

- Net loss: $100,000
- Increase in accounts payable: $40,000
- Depreciation expense: $35,000
- Decrease in gross amount of trade accounts receivable: $60,000
- Purchase of office equipment on 45-day credit terms: $15,000
- Provision for estimated warranty liability: $10,000

How much change in cash position is expected for February?
- $15,000 decrease.
- $25,000 decrease.
- $30,000 increase.
- $45,000 increase.

1N81#25. Peters Company uses a flexible budget system and prepared the following information for 1980:

<table>
<thead>
<tr>
<th>Percent of capacity</th>
<th>80%</th>
<th>90%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct-labor hours</td>
<td>24,000</td>
<td>27,000</td>
</tr>
<tr>
<td>Variable factory overhead</td>
<td>$48,000</td>
<td>$54,000</td>
</tr>
<tr>
<td>Fixed factory overhead</td>
<td>$108,000</td>
<td>$108,000</td>
</tr>
<tr>
<td>Total factory overhead rate per direct-labor hour</td>
<td>$6.50</td>
<td>$6.00</td>
</tr>
</tbody>
</table>

Peters operated at 80% of capacity during 1980, but applied factory overhead based on the 90% capacity level. Assuming that actual factory overhead was equal to the budgeted amount for the attained capacity, what is the amount of overhead variance for the year?
- $6,000 overabsorbed.
- $6,000 underabsorbed.
- $12,000 overabsorbed.
- $12,000 underabsorbed.

1N81#33. Juniper Company is preparing its cash budget for the month of August 1981. Projections for the month include the following:

- Sales: $400,000
- Gross profit (based on sales): 25%
- Increase in inventories: $30,000
- Decrease in trade accounts payable: $12,000

What are the estimated cash disbursements for inventories in August 1981?
- $142,000
- $312,000
- $318,000
- $342,000

1N81#34. Mapes Corporation has estimated its activity for January 1981. Selected data from these estimated amounts are as follows:

- Sales: $1,400,000
- Gross profit (based on sales): 30%
- Increase in trade accounts receivable during month: $40,000
- Change in accounts payable during month: $0
- Increase in inventory during month: $20,000

What are the estimated cash disbursements for January 1981?
- Sales: $1,238,000
- Collections of accounts receivable: $1,800,000
- Cost of goods sold: $1,400,000
- Disbursements for purchases of merchandise and expenses: $1,200,000
- Disbursements for income taxes: $250,000
- Depreciation expense: $80,000
- Proceeds from borrowings: $700,000
- Payments on borrowings: $80,000

The projected cash balance at December 31, 1981, is:
- $1,170,000
- $1,220,000
- $1,370,000
- $1,820,000

1N81#24. Fields Corporation projects the following transactions for 1981, its first year of operations:

- Proceeds from issuance of common stock: $1,000,000
- Sales on account: $2,200,000
- Collections of accounts receivable: $1,800,000
- Cost of goods sold: $1,400,000
- Disbursements for purchases of merchandise and expenses: $1,200,000
- Depreciation on fixed assets: $150,000
- Proceeds from borrowings: $700,000
- Payments on borrowings: $80,000

What are the estimated cash disbursements for January 1981?
- Sales: $1,238,000
- Gross profit (based on sales): $1,400,000
- Increase in accounts receivable: $40,000
- Change in accounts payable during month: $0
- Increase in inventory during month: $20,000
- Variable selling, general and administrative expenses (S, G & A) include a charge for uncollectible accounts of 1% of sales.
- Total S, G & A is $142,000 per month plus 15% of sales.
- Depreciation expense of $80,000 per month is included in fixed S, G & A.

AP-90
Selected Questions

G. Breakeven and Cost-Volume-Profit Analysis

2N84

Items 14 and 15 are based on the following data:

The following information pertains to Rica Company:

<table>
<thead>
<tr>
<th>Sales (50,000 units)</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials and direct labor</td>
<td>300,000</td>
</tr>
<tr>
<td>Factory overhead: Variable</td>
<td>40,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>70,000</td>
</tr>
<tr>
<td>Selling and general expenses: Variable</td>
<td>10,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>60,000</td>
</tr>
</tbody>
</table>

14. How much was Rica's break-even point in number of units?
   a. 9,848
   b. 10,000
   c. 18,571
   d. 26,000

15. What was Rica's contribution margin ratio?
   a. 66%
   b. 65%
   c. 59%
   d. 35%

2N83

Items 10 and 11 are based on the following data:

Kalik Co. sells radios for $60 each. Variable expenses are $40 per unit, while fixed expenses total $30,000.

10. How many radios must Kalik sell to earn an operating income of $70,000?
    a. 5,000
    b. 3,500
    c. 2,500
    d. 1,500

11. What total dollar amount must Kalik sell to break even?
    a. $40,000
    b. $75,000
    c. $90,000
    d. $120,000

2N83#12. Koby Co. has sales of $200,000 with variable expenses of $150,000, fixed expenses of $60,000, and an operating loss of $10,000. By how much would Koby have to increase its sales in order to achieve an operating income of 10% of sales?
    a. $400,000
    b. $251,000
    c. $231,000
    d. $200,000

1N82#31. During March 1982 Adams Company had sales of $5,000,000, variable costs of $3,000,000 and fixed costs of $1,500,000 for product M. Assume that cost behavior and unit selling price remain unchanged during April. In order for Adams to realize operating income of $300,000 from product M for April, sales would have to be
   a. $3,750,000
   b. $4,050,000
   c. $4,500,000
   d. $4,800,000

1N82#39. Wilson Company prepared the following preliminary forecast concerning product G for 1982 assuming no expenditure for advertising:

<table>
<thead>
<tr>
<th>Selling price per unit</th>
<th>$10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit sales</td>
<td>100,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td>$600,000</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

Based on a market study in December 1981, Wilson estimated that it could increase the unit selling price by 15% and increase the unit sales volume by 10% if $100,000 were spent on advertising. Assuming that Wilson incorporates these changes in its 1982 forecast, what should be the operating income from product G?
   a. $175,000
   b. $190,000
   c. $205,000
   d. $365,000

2N82#27. Marling Company is contemplating an expansion program based on the following budget data:

<table>
<thead>
<tr>
<th>Expected sales</th>
<th>$600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable costs</td>
<td>420,000</td>
</tr>
<tr>
<td>Fixed expenses</td>
<td>120,000</td>
</tr>
</tbody>
</table>

What is the amount of break-even sales?
   a. $400,000
   b. $420,000
   c. $540,000
   d. $660,000

2N82#29. Spencer Company's regular selling price for its product is $10 per unit. Variable costs are $6 per unit. Fixed costs total $1 per unit based on 100,000 units, and remain unchanged within the relevant range of 50,000 units to total capacity of 200,000 units. After sales of 80,000 units were projected for 1982, a special order was received for an additional 10,000 units. To increase its operating income by $10,000, what price per unit should Spencer charge for this special order?
   a. $7
   b. $8
   c. $10
   d. $11
2N82#33. Purvis Company manufactures a product that has a variable cost of $50 per unit. Fixed costs total $1,000,000, allocated on the basis of the number of units produced. Selling price is computed by adding a 10% markup to full cost. How much should the selling price be per unit for 100,000 units?

a. $55  
b. $60  
c. $61  
d. $66

1N82#33. Kern Company prepared the following tentative forecast concerning product A for 1982:

Sales $500,000  
Selling price per unit $5.00  
Variable costs $300,000  
Fixed costs $150,000

A study made by the sales manager disclosed that the unit selling price could be increased by 20%, with an expected volume decrease of only 10%. Assuming that Kern incorporates these changes in its 1982 forecast, what should be the operating income from product A?

a. $66,000  
b. $90,000  
c. $120,000  
d. $145,000

1N82#34. Singer, Inc., sells product R for $5 per unit. The fixed costs are $210,000 and the variable costs are 60% of the selling price. What would be the amount of sales if Singer is to realize a profit of 10% of sales?

a. $700,000  
b. $525,000  
c. $472,500  
d. $420,000

1N81#30. Pitt Company is considering a proposal to replace existing machinery used for the manufacture of product A. The new machines are expected to cause increased annual fixed costs of $120,000; however, variable costs should decrease by 20% due to a reduction in direct-labor hours and more efficient usage of direct materials. Before this change was under consideration, Pitt had budgeted product A sales and costs for 1981 as follows:

Sales $2,000,000  
Variable costs 70% of sales  
Fixed costs $400,000

Assuming that Pitt implemented the above proposal by January 1, 1981, what would be the increase in budgeted operating profit for product A for 1981?

a. $160,000  
b. $280,000  
c. $360,000  
d. $480,000

1N81#32. Lindsay Company reported the following results from sales of 5,000 units of product A for the month of June 1981:

Sales $200,000  
Variable costs 120,000  
Fixed costs 60,000  
Operating income 20,000

Assume that Lindsay increases the selling price of product A by 10% on July 1, 1981. How many units of product A would have to be sold in July 1981 in order to generate an operating income of $20,000?

a. 4,000  
b. 4,300  
c. 4,500  
d. 5,000

1N81#34. Birney Company is planning its advertising campaign for 1981 and has prepared the following budget data based on a zero advertising expenditure:

Normal plant capacity 200,000 units  
Sales 150,000 units  
Selling price $25.00 per unit  
Variable manufacturing costs $15.00 per unit  
Fixed costs:
  Manufacturing $800,000  
  Selling and administrative $700,000

An advertising agency claims that an aggressive advertising campaign would enable Birney to increase its unit sales by 20%. What is the maximum amount that Birney can pay for advertising and obtain an operating profit of $200,000?

a. $100,000  
b. $200,000  
c. $300,000  
d. $550,000

1N81#35. In planning its operations for 1981 based on a sales forecast of $6,000,000, Wallace, Inc., prepared the following estimated data:

<table>
<thead>
<tr>
<th>Costs and expenses</th>
<th>Variable</th>
<th>Fixed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$1,600,000</td>
<td></td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,400,000</td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>600,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>240,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>60,000</td>
<td>140,000</td>
</tr>
<tr>
<td></td>
<td>$3,900,000</td>
<td>$1,400,000</td>
</tr>
</tbody>
</table>

What would be the amount of sales dollars at the break-even point?

a. $2,250,000  
b. $3,500,000  
c. $4,000,000  
d. $5,300,000
Selected Questions

1M81#35. Warfield Company is planning to sell 100,000 units of product I for $12.00 a unit. The fixed costs are $280,000. In order to realize a profit of $200,000, what would the variable costs be?
   a. $480,000  
   b. $720,000  
   c. $900,000  
   d. $920,000

1M81#36. Sun Company’s tentative budget for product H for 1981 is as follows:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable manufacturing costs</td>
<td>360,000</td>
</tr>
<tr>
<td>Fixed costs:</td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td>90,000</td>
</tr>
<tr>
<td>Selling and administrative costs</td>
<td>110,000</td>
</tr>
</tbody>
</table>

Mr. Johnston, the marketing manager, proposes an aggressive advertising campaign costing an additional $50,000 and resulting in a 30% unit sales increase for product H. Assuming that Johnston’s proposal is incorporated into the budget for product H, what should be the increase in the budgeted operating profit for 1981?
   a. $12,000  
   b. $22,000  
   c. $72,000  
   d. $130,000

1M81#40. Gerber Company is planning to sell 200,000 units of product O for $2.00 a unit. The contribution margin is 25%. Gerber will break even at this level of sales. What would be the fixed costs?
   a. $100,000  
   b. $160,000  
   c. $200,000  
   d. $300,000

H. Capital Budgeting Techniques

2M85#13. Oran Co. has the opportunity to invest in a two-year project which is expected to produce cash flows from operations, net of income taxes, of $100,000 in the first year and $200,000 in the second year. Oran requires an internal rate of return of 20%. The present value of $1 for one period at 20% is 0.833 and for two periods at 20% is 0.694. For this project, Oran should be willing to invest immediately a maximum of
   a. $283,300  
   b. $249,900  
   c. $222,100  
   d. $208,200

2N84#18. Axel Corp. is planning to buy a new machine with the expectation that this investment should earn a discounted rate of return of at least 15%. This machine, which costs $150,000, would yield an estimated net cash flow of $30,000 a year for 10 years, after income taxes. In order to determine the net present value of buying the new machine, Axel should first multiply the $30,000 by which of the following factors?
   a. 20.304 (Future amount of an ordinary annuity of $1).
   b. 5.019 (Present value of an ordinary annuity of $1).
   c. 4.046 (Future amount of $1).
   d. 0.247 (Present value of $1).

2N83

Items 17 and 18 are based on the following data:

Amaro Hospital, a nonprofit institution not subject to income taxes, is considering the purchase of new equipment costing $20,000, in order to achieve cash savings of $5,000 per year in operating costs. The equipment’s estimated useful life is ten years, with no net residual value. Amaro’s cost of capital is 14%. For ten periods at 14%, the present value of $1 is 0.270, while the present value of an ordinary annuity of $1 is 5.216.

17. What factor contained in or developed from the above information should be used in computing the internal rate of return for Amaro’s proposed investment in the new equipment?
   a. 5.216  
   b. 4.000  
   c. 1.400  
   d. 0.270

18. How much is the accounting rate of return based on Amaro’s initial investment in the new equipment?
   a. 27%  
   b. 25%  
   c. 15%  
   d. 14%

1M83#40. Dillon, Inc., purchased a new machine for $60,000 on January 1, 1983. The machine is being depreciated on the straight-line basis over five years with no salvage value. The accounting (book value) rate of return is expected to be 15% on the initial increase in required investment. Assuming a uniform cash flow, this investment is expected to provide annual cash flow from operations, net of income taxes, of
   a. $7,200  
   b. $12,000  
   c. $13,800  
   d. $21,000

1N82#26. Heller Company purchased a machine for $500,000 with a useful life of five years and no salvage value. The machine is being depreciated using the straight-line method and it is expected to produce annual cash flow from operations, net of income taxes, of $150,000. The present value of an ordinary annuity of $1 for five periods at 14% is 3.43. The present value
of $1 for five periods at 14% is 0.52. Assuming that Heller uses a time-adjusted rate of return of 14%, what is the net present value?

a. $280,000  
b. $250,000  
c. $180,000  
d. $ 14,500

1N82

Items 36 and 37 are based on the following information:

Hanley Company purchased a machine for $125,000 which will be depreciated on the straight-line basis over a five-year period with no salvage value. The related cash flow from operations, net of income taxes, is expected to be $45,000 a year. Assume that Hanley’s effective income tax rate is 40% for all years.

36. What is the payback period?
   a. 2.1 years.  
b. 2.3 years.  
c. 2.8 years.  
d. 4.2 years.

37. What is the accounting (book value) rate of return on the initial increase in required investment?
   a. 16%  
b. 24%  
c. 28%  
d. 36%

1N82#40. Kipling Company invested in an eight-year project. It is expected that the annual cash flow from the project, net of income taxes, will be $20,000. Information on present value factors is as follows:

<table>
<thead>
<tr>
<th>Present value of $1 at 12% for eight periods</th>
<th>Present value of an ordinary annuity of $1 at 12% for eight periods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of $1 at 12% for eight periods</td>
<td>Present value of an ordinary annuity of $1 at 12% for eight periods</td>
</tr>
<tr>
<td>0.404</td>
<td>4.968</td>
</tr>
</tbody>
</table>

Assuming that Kipling based its investment decision on an internal rate of return of 12%, how much did the project cost?

a. $160,000  
b. $ 99,360  
c. $ 80,800  
d. $ 64,640

1M82#37. On January 1, 1981, Studley Company purchased a new machine for $100,000 with an estimated useful life of five years and no salvage value. For book and tax purposes, the machine will be depreciated using the straight-line method and it is expected to produce annual cash flow from operations, before income taxes, of $40,000. Assume that Studley uses a time-adjusted rate of 12% and that its income tax rate will be 40% for all years. The present value of $1 at 12% for five periods is 0.57, and the present value of an ordinary annuity of $1 at 12% for five periods is 3.61. The net present value of the machine should be

a. $15,520 positive.  
b. $15,520 negative.  
c. $14,000 positive.  
d. $13,680 negative.

1M82#38. Hamilton Company invested in a two-year project having an internal rate of return of 12%. The project is expected to produce cash flow from operations, net of income taxes, of $60,000 in the first year and $70,000 in the second year. The present value of $1 for one period at 12% is 0.893 and for two periods at 12% is 0.797. How much will the project cost?

a. $103,610  
b. $109,370  
c. $116,090  
d. $122,510

1N81#36. Nelson Company is planning to purchase a new machine for $500,000. The new machine is expected to produce cash flow from operations, before income taxes, of $135,000 a year in each of the next five years. Depreciation of $100,000 a year will be charged to income for each of the next five years. Assume that the income tax rate is 40%. The payback period would be approximately

a. 2.2 years.  
b. 3.4 years.  
c. 3.7 years.  
d. 4.1 years.

1N81#37. Hillsdale Company purchased a machine for $480,000. The machine has a useful life of six years and no salvage value. Straight-line depreciation is to be used. The machine is expected to generate cash flow from operations, net of income taxes, of $140,000 in each of the six years. Hillsdale’s desired rate of return is 14%. Information on present value factors is as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Present value of $1 at 14%</th>
<th>Present value of ordinary annuity of $1 at 14%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.877</td>
<td>.877</td>
</tr>
<tr>
<td>2</td>
<td>.769</td>
<td>1.647</td>
</tr>
<tr>
<td>3</td>
<td>.675</td>
<td>2.322</td>
</tr>
<tr>
<td>4</td>
<td>.592</td>
<td>2.914</td>
</tr>
<tr>
<td>5</td>
<td>.519</td>
<td>3.433</td>
</tr>
<tr>
<td>6</td>
<td>.456</td>
<td>3.889</td>
</tr>
</tbody>
</table>

AP-94
What would be the net present value?

- a. $ 63,840
- b. $ 64,460
- c. $218,880
- d. $233,340

1N81#38. Saratoga Company is planning to purchase a new machine for $600,000. The new machine will be depreciated on the straight-line basis over a six-year period with no salvage, and a full year's depreciation will be taken in the year of acquisition. The new machine is expected to produce cash flow from operations, net of income taxes, of $150,000 a year in each of the next six years. The accounting (book value) rate of return on the initial investment is expected to be

- a. 8.3%
- b. 12.0%
- c. 16.7%
- d. 25.0%

1N81#39. Garwood Company purchased a machine which will be depreciated on the straight-line basis over an estimated useful life of seven years and no salvage value. The machine is expected to generate cash flow from operations, net of income taxes, of $80,000 in each of the seven years. Garwood's expected rate of return is 12%. Information on present value factors is as follows:

| Present value of $1 at 12% for seven periods | 0.452 |
| Present value of an ordinary annuity of $1 at 12% for seven periods | 4.564 |

Assuming a positive net present value of $12,720, what was the cost of the machine?

- a. $240,400
- b. $253,120
- c. $352,400
- d. $377,840

1M81#21. Tracy Corporation is planning to invest $80,000 in a three-year project. Tracy's expected rate of return is 10%. The present value of $1 at 10% for one year is .909, for two years is .826, and for three years is .751. The cash flow, net of income taxes, will be $30,000 for the first year (present value of $27,270) and $36,000 for the second year (present value of $29,736). Assuming the rate of return is exactly 10%, what will the cash flow, net of income taxes, be for the third year?

- a. $17,268
- b. $22,000
- c. $22,994
- d. $30,618

I. Performance Analysis

2M85

Items 18 and 19 are based on the following data:

The following selected data pertain to Beck Co.'s Beam Division for 1984:

| Sales | $1,000,000 |
| Variable costs | $600,000 |
| Traceable fixed costs | $100,000 |
| Average invested capital | $200,000 |
| Imputed interest rate | 15% |

AP-95
18. How much is the residual income?
a. $100,000
b. $270,000
c. $300,000
d. $330,000

19. How much is the return on investment?
a. 75%
b. 135%
c. 150%
d. 200%

2M85#17. Olex Co. is considering a proposal to introduce a new product called Vee. An outside marketing consultant prepared the following probability distribution indicating the relative likelihood of monthly sales volume levels and related income (loss) for Vee:

<table>
<thead>
<tr>
<th>Monthly sales volume</th>
<th>Probability</th>
<th>Income (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>6,000</td>
<td>.10</td>
<td>$(70,000)</td>
</tr>
<tr>
<td>12,000</td>
<td>.20</td>
<td>10,000</td>
</tr>
<tr>
<td>18,000</td>
<td>.40</td>
<td>60,000</td>
</tr>
<tr>
<td>24,000</td>
<td>.20</td>
<td>100,000</td>
</tr>
<tr>
<td>30,000</td>
<td>.10</td>
<td>140,000</td>
</tr>
</tbody>
</table>

If Olex decides to market Vee, the expected value of the added monthly income will be
a. $240,000
b. $60,000
c. $53,000
d. $48,000

2M85#20. Box Co. has developed the following regression equation to analyze the behavior of its maintenance costs (Y) as a function of machine hours (X):

\[ Y = 12,000 + 10.50X. \]

Thirty monthly observations were used to develop the foregoing equation. The related coefficient of determination was .90. If 1,000 machine hours are worked in one month, the related point estimate of total variable maintenance costs would be
a. $9,450
b. $10,500
c. $11,500
d. $22,500

1N83#50. The manufacturing capacity of Jordan Company’s facilities is 30,000 units of product a year. A summary of operating results for the year ended December 31, 1982, is as follows:

<table>
<thead>
<tr>
<th>Sales (18,000 units @ $100)</th>
<th>$1,800,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable manufacturing and selling costs</td>
<td>990,000</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>810,000</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>495,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>$315,000</td>
</tr>
</tbody>
</table>

A foreign distributor has offered to buy 15,000 units at $90 per unit during 1983. Assume that all of Jordan’s costs would be at the same levels and rates in 1983 as
in 1982. If Jordan accepted this offer and rejected some business from regular customers so as not to exceed capacity, what would be the total operating income for 1983?

a. $390,000  
b. $705,000  
c. $840,000  
d. $855,000

1N83#53. Barclay Company sells 20,000 pocket calculators evenly throughout the year. The cost of carrying one unit in inventory for one year is $4 and the purchase order cost per order is $64. What is the economic order quantity?

a. 400  
b. 566  
c. 800  
d. 1,250

1N83#59. Rice Corporation currently operates two divisions which had operating results for the year ended December 31, 1982, as follows:

<table>
<thead>
<tr>
<th></th>
<th>West Division</th>
<th>Troy Division</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$600,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td>310,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>290,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Fixed costs for the Division</td>
<td>110,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Margin over direct costs</td>
<td>180,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Allocated corporate costs</td>
<td>90,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>$ 90,000</td>
<td>$(15,000)</td>
</tr>
</tbody>
</table>

Since the Troy Division also sustained an operating loss during 1981, Rice’s president is considering the elimination of this division. Assume that the Troy Division fixed costs could be avoided if the division were eliminated. If the Troy Division had been eliminated on January 1, 1982, Rice Corporation’s 1982 operating income would have been

a. $15,000 higher.  
b. $30,000 lower.  
c. $45,000 lower.  
d. $60,000 higher.

The expected value of the monthly income from RLX is

a. $48,000  
b. $53,000  
c. $60,000  
d. $240,000

2N83#5. Balan Co.’s pricing structure has been formulated to yield a gross margin of 40%. The following data pertain to the year ended December 31, 1982:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$600,000</td>
</tr>
<tr>
<td>Beginning inventory</td>
<td>100,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>400,000</td>
</tr>
<tr>
<td>Physical inventory at year-end</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Balan is satisfied that all sales and purchases have been fully and properly recorded. How much might Balan reasonably estimate as missing inventory at December 31, 1982?

a. $0  
b. $40,000  
c. $140,000  
d. $160,000

1N82#35. Jordan Company budgeted sales of 400,000 calculators at $40 per unit for 1982. Variable manufacturing costs were budgeted at $16 per unit, and fixed manufacturing costs at $10 per unit. A special order offering to buy 40,000 calculators for $23 each was received by Jordan in March 1982. Jordan has sufficient plant capacity to manufacture the additional quantity; however, the production would have to be done on an overtime basis at an estimated additional cost of $3 per calculator. Acceptance of the special order would not affect Jordan’s normal sales and no selling expenses would be incurred. What would be the effect on operating profit if the special order were accepted?

a. $120,000 decrease.  
b. $160,000 increase.  
c. $240,000 decrease.  
d. $280,000 increase.

2N82#21. Manor Company plans to discontinue a department with a contribution to overhead of $24,000 and allocated overhead of $48,000, of which $21,000 cannot be eliminated. The effect of this discontinuance on Manor’s pretax profit would be a (an)

a. Decrease of $3,000.  
b. Increase of $3,000.  
c. Decrease of $24,000.  
d. Increase of $24,000.

2N82#34. Mori Company plans to begin production of a new product on July 1, 1983. An 80% learning curve is applicable to Mori’s manufacturing operations.
1M82#35. In planning its budget for 1982, King Company prepared the following payoff probability distribution describing the relative likelihood of monthly sales volume levels and related contribution margins for product A:

<table>
<thead>
<tr>
<th>Monthly sales volume</th>
<th>Contribution margin</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>4,000</td>
<td>$80,000</td>
<td>.20</td>
</tr>
<tr>
<td>6,000</td>
<td>120,000</td>
<td>.25</td>
</tr>
<tr>
<td>8,000</td>
<td>160,000</td>
<td>.30</td>
</tr>
<tr>
<td>10,000</td>
<td>200,000</td>
<td>.15</td>
</tr>
<tr>
<td>12,000</td>
<td>240,000</td>
<td>.10</td>
</tr>
</tbody>
</table>

What is the expected value of the monthly contribution margin for product A?

a. $140,000  
b. $148,000  
c. $160,000  
d. $180,000

1N81#23. Lincoln Company, a glove manufacturer, has enough idle capacity available to accept a special order of 20,000 pairs of gloves at $12.00 a pair. The normal selling price is $20.00 a pair. Variable manufacturing costs are $9.00 a pair, and fixed manufacturing costs are $3.00 a pair. Lincoln will not incur any selling expenses as a result of the special order. What would be the effect on operating income if the special order could be accepted without affecting normal sales?

a. $0.  
b. $60,000 increase.  
c. $180,000 increase.  
d. $240,000 increase.

1N81#31. Garfield Company, which sells a single product, provided the following data from its income statements for the calendar years 1980 and 1979:

<table>
<thead>
<tr>
<th>1980</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (150,000 units)</td>
<td>$750,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>525,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$225,000</td>
</tr>
<tr>
<td>(Base year)</td>
<td></td>
</tr>
<tr>
<td>Sales (180,000 units)</td>
<td>$720,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>575,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$145,000</td>
</tr>
</tbody>
</table>

In an analysis of variation in gross profit between the two years, what would be the effects of changes in sales price and sales volume?
Selected Questions

Sales price                  Sales volume
a. $150,000 favorable  $120,000 unfavorable
b. $150,000 unfavorable  $120,000 favorable
c. $180,000 favorable  $150,000 unfavorable
d. $180,000 unfavorable  $150,000 favorable

1M81#40. Kingston Company needs 10,000 units of a certain part to be used in its production cycle. The following information is available:

Cost to Kingston to make the part:
- Direct materials: $6
- Direct labor: 24
- Variable overhead: 12
- Fixed overhead applied: 15

Total: $57

Cost to buy the part from Utica Company: $53

If Kingston buys the part from Utica instead of making it, Kingston could not use the released facilities in another manufacturing activity. 60% of the fixed overhead applied will continue regardless of what decision is made.

In deciding whether to make or buy the part, the total relevant costs to make the part are:
- a. $342,000
- b. $480,000

1M81#29. Plainfield Company manufactures part G for use in its production cycle. The costs per unit for 10,000 units of part G are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$3</td>
</tr>
<tr>
<td>Direct labor</td>
<td>$15</td>
</tr>
<tr>
<td>Variable overhead</td>
<td>$6</td>
</tr>
<tr>
<td>Fixed overhead</td>
<td>$8</td>
</tr>
<tr>
<td></td>
<td>$32</td>
</tr>
</tbody>
</table>

Verona Company has offered to sell Plainfield 10,000 units of part G for $30 per unit. If Plainfield accepts Verona’s offer, the released facilities could be used to save $45,000 in relevant costs in the manufacture of part H. In addition $5 per unit of the fixed overhead applied to part G would be totally eliminated. What alternative is more desirable and by what amount is it more desirable?

<table>
<thead>
<tr>
<th>Alternative</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Manufacture</td>
<td>$10,000</td>
</tr>
<tr>
<td>b. Manufacture</td>
<td>$15,000</td>
</tr>
<tr>
<td>c. Buy</td>
<td>$35,000</td>
</tr>
<tr>
<td>d. Buy</td>
<td>$65,000</td>
</tr>
</tbody>
</table>

VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting

2M84

Items 52 through 54 are based on the following data:

The Board of Commissioners of Vane City adopted its budget for the year ending July 31, 1985, comprising estimated revenues of $30,000,000 and appropriations of $29,000,000. Vane formally integrates its budget into the accounting records.

52. What entry should be made for budgeted revenues?
   a. Memorandum entry only.
   b. Debit estimated revenues receivable control, $30,000,000.
   c. Debit estimated revenues control, $30,000,000.
   d. Credit estimated revenues control, $30,000,000.

53. What entry should be made for budgeted appropriations?
   a. Memorandum entry only.
   b. Credit estimated expenditures payable control, $29,000,000.
   c. Credit appropriations control, $29,000,000.
   d. Debit estimated expenditures control, $29,000,000.

54. What entry should be made for the budgeted excess of revenues over appropriations?
   a. Memorandum entry only.
   b. Credit budgetary fund balance, $1,000,000.
   c. Debit estimated excess revenues control, $1,000,000.
   d. Debit excess revenues receivable control, $1,000,000.

2M84

Items 59 and 60 are based on the following data:

Albee Township's fiscal year ends on June 30. Albee uses encumbrance accounting. On April 5, 1984, an approved $1,000 purchase order was issued for sup-
plies. Albee received these supplies on May 2, 1984, and the $1,000 invoice was approved for payment.

59. What journal entry should Albee make on April 5, 1984, to record the approved purchase order?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Memorandum entry only</td>
<td>—</td>
</tr>
<tr>
<td>b. Encumbrances control</td>
<td>$1,000</td>
</tr>
<tr>
<td>Fund balance reserved for encumbrances</td>
<td>$1,000</td>
</tr>
<tr>
<td>c. Supplies Vouchers payable</td>
<td>1,000</td>
</tr>
<tr>
<td>d. Encumbrances control</td>
<td>Appropriations control</td>
</tr>
<tr>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

60. What journal entry or entries should Albee make on May 2, 1984, upon receipt of the supplies and approval of the invoice?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Appropriations control</td>
<td>$1,000</td>
</tr>
<tr>
<td>Encumbrances control</td>
<td>$1,000</td>
</tr>
<tr>
<td>Supplies Vouchers payable</td>
<td>1,000</td>
</tr>
<tr>
<td>b. Supplies Vouchers payable</td>
<td>1,000</td>
</tr>
<tr>
<td>c. Fund balance reserved for encumbrances</td>
<td>1,000</td>
</tr>
<tr>
<td>Encumbrances control</td>
<td>Expenditures control</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>Vouchers payable</td>
</tr>
<tr>
<td>d. Encumbrances control</td>
<td>Appropriations control</td>
</tr>
<tr>
<td>Fund balance Vouchers payable</td>
<td>1,000</td>
</tr>
</tbody>
</table>

2M82#28. The Board of Commissioners of the City of Rockton adopted its budget for the year ending July 31, 1982, which indicated revenues of $1,000,000 and appropriations of $900,000. If the budget is formally integrated into the accounting records, what is the required journal entry?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Memorandum entry only</td>
<td>—</td>
</tr>
<tr>
<td>b. Appropriations</td>
<td>$900,000</td>
</tr>
<tr>
<td>General fund</td>
<td>100,000</td>
</tr>
<tr>
<td>Estimated revenues</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>c. Estimated revenues</td>
<td>$900,000</td>
</tr>
<tr>
<td>Appropriations Fund balance</td>
<td>100,000</td>
</tr>
<tr>
<td>d. Revenues receivable</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Expenditures payable</td>
<td>$900,000</td>
</tr>
<tr>
<td>General fund balance</td>
<td>100,000</td>
</tr>
</tbody>
</table>

2M82#29. Kingsford City incurred $100,000 of salaries and wages for the month ended March 31, 1982. How should this be recorded at that date?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Expenditures - salaries and wages</td>
<td>$100,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>$100,000</td>
</tr>
<tr>
<td>b. Salaries and wages expense</td>
<td>$100,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>$100,000</td>
</tr>
<tr>
<td>c. Encumbrances - salaries and wages</td>
<td>$100,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>$100,000</td>
</tr>
<tr>
<td>d. Fund balance</td>
<td>$100,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

B. Types of Funds and Fund Accounts

2M84

Items 41 through 43 are based on the following data:

Under Abbey Hospital's established rate structure, the hospital would have earned patient service revenue of $6,000,000 for the year ended December 31, 1983. However, Abbey did not expect to collect this amount because of charity allowances of $1,000,000 and discounts of $500,000 to third-party payors. In May 1983, Abbey purchased bandages from Lee Supply Co. at a cost of $1,000. However, Lee notified Abbey that the invoice was being cancelled and that the bandages were being donated to Abbey. At December 31, 1983, Abbey had board-designated assets consisting of cash $40,000, and investments $700,000.

43. How much of Abbey's board-designated assets should be included in the unrestricted fund grouping?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td></td>
</tr>
<tr>
<td>b. $40,000</td>
<td></td>
</tr>
<tr>
<td>c. $700,000</td>
<td></td>
</tr>
<tr>
<td>d. $740,000</td>
<td></td>
</tr>
</tbody>
</table>

AP-100
2M84#47. Fred Bosin donated a building to Palma City in 1983. Bosin's original cost of the property was $100,000. Accumulated depreciation at the date of the gift amounted to $60,000. Fair market value at the date of the gift was $300,000. In the general fixed assets account group, at what amount should Palma record this donated fixed asset?
   a. $300,000
   b. $100,000
   c. $ 40,000
   d. $0

2M84
Items 48 through 50 are based on the following data relating to Lely Township:

Printing and binding equipment used for servicing all of Lely’s departments and agencies, on a cost-reimbursement basis $100,000

Equipment used for supplying water to Lely’s residents 900,000

Receivables for completed sidewalks to be paid for installments by affected property owners 950,000

Cash received from federal government, dedicated to highway maintenance, which must be accounted for in a separate fund 995,000

48. How much should be accounted for in a special revenue fund or funds?
   a. $ 995,000
   b. $1,050,000
   c. $1,095,000
   d. $2,045,000

49. How much could be accounted for in an internal service fund?
   a. $100,000
   b. $900,000
   c. $950,000
   d. $995,000

50. How much could be accounted for in an enterprise fund?
   a. $100,000
   b. $900,000
   c. $950,000
   d. $995,000

2M84#57. The following items were among Payne Township's general fund expenditures during the year ended July 31, 1983:

Minicomputer for tax collector's office $44,000
Equipment for Township Hall 80,000

How much should be classified as fixed assets in Payne's general fund balance sheet at July 31, 1983?
   a. $124,000
   b. $ 80,000
   c. $ 44,000
   d. $0

2M84#58. Ariel Village issued the following bonds during the year ended June 30, 1983:

For installation of street lights, to be assessed against properties benefited $300,000

For construction of public swimming pool; bonds to be paid from pledged fees collected from pool users 400,000

How much should be accounted for through debt service funds for payments of principal over the life of the bonds?
   a. $0
   b. $300,000
   c. $400,000
   d. $700,000

2M82#22. The following assets are among those owned by the City of Foster:

Apartment building (part of the principal of a nonexpendable trust fund) $ 200,000
City Hall 800,000
Three fire stations 1,000,000
City streets and sidewalks 5,000,000

How much should be included in Foster’s general fixed assets account group?
   a. $1,800,000 or $6,800,000.
   b. $2,000,000 or $7,000,000.
   c. $6,800,000, without election of $1,800,000.
   d. $7,000,000, without election of $2,000,000.

2M82
Items 26 and 27 are based on the following information:

The following events relating to the City of Albury's debt service funds occurred during the year ended December 31, 1981:

Debt principal matured $2,000,000
Unmatured (accrued) interest on outstanding debt at Jan. 1, 1981 50,000
Interest on matured debt 900,000
Unmatured (accrued) interest on outstanding debt at Dec. 31, 1981 100,000
Interest revenue from investments 600,000
Cash transferred from general fund for retirement of debt principal 1,000,000
Cash transferred from general fund for payment of matured interest 900,000

All principal and interest due in 1981 were paid on time.
26. What is the total amount of expenditures that Albury's debt service funds should record for the year ended December 31, 1981?
   a. $ 900,000
   b. $ 950,000
   c. $2,900,000
   d. $2,950,000

27. How much revenue should Albury's debt service funds record for the year ended December 31, 1981?
   a. $ 600,000
   b. $1,600,000
   c. $1,900,000
   d. $2,500,000

2M82
Items 32 and 33 are based on the following information:

During the year ended December 31, 1981, Leyland City received a state grant of $500,000 to finance the purchase of buses, and an additional grant of $100,000 to aid in the financing of bus operations in 1981. Only $300,000 of the capital grant was used in 1981 for the purchase of buses, but the entire operating grant of $100,000 was spent in 1981.

32. If Leyland's bus transportation system is accounted for as part of the city's general fund, how much should Leyland report as grant revenues for the year ended December 31, 1981?
   a. $100,000
   b. $300,000
   c. $400,000
   d. $500,000

33. If Leyland's bus transportation system is accounted for as an enterprise fund, how much should Leyland report as grant revenues for the year ended December 31, 1981?
   a. $100,000
   b. $300,000
   c. $400,000
   d. $500,000

2M82#35. Ariel Village issued the following bonds during the year ended June 30, 1981:

Revenue bonds to be repaid from admission fees collected by the Ariel Zoo enterprise fund $200,000
General obligation bonds issued for the Ariel water and sewer enterprise fund which will service the debt 300,000

How much of these bonds should be accounted for in Ariel's general long-term debt account group?
   a. $0
   b. $200,000
   c. $300,000
   d. $500,000

2M82
Items 36 and 37 are based on the following information:

On December 31, 1981, Madrid Township paid a contractor $2,000,000 for the total cost of a new firehouse built in 1981 on Township-owned land. Financing was by means of a $1,500,000 general obligation bond issue sold at face amount on December 31, 1981, with the remaining $500,000 transferred from the general fund.

36. What should be reported on Madrid's 1981 financial statements for the capital project fund?
   a. Revenues, $1,500,000; Expenditures, $1,500,000.
   b. Revenues, $1,500,000; Other financing sources, $500,000; Expenditures, $2,000,000.
   c. Revenues, $2,000,000; Expenditures, $2,000,000.
   d. Other financing sources, $2,000,000; Expenditures, $2,000,000.

37. What should be reported on Madrid's 1981 financial statements for the general fund?
   a. Expenditures, $500,000.
   b. Other financing uses, $500,000.
   c. Revenues, $1,500,000; Expenditures, $2,000,000.
   d. Revenues, $1,500,000; Other financing uses, $2,000,000.

C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

2M82
Items 38 and 39 are based on the following information:

The following balances appeared in the City of Reedsbury's general fund at June 30, 1981:

<table>
<thead>
<tr>
<th>Account</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Encumbrances — current year</td>
<td>$200,000</td>
</tr>
<tr>
<td>Expenditures:</td>
<td></td>
</tr>
<tr>
<td>Current year</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Prior year</td>
<td>100,000</td>
</tr>
<tr>
<td>Fund balance reserved for encumbrances:</td>
<td></td>
</tr>
<tr>
<td>Current year</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Prior year</td>
<td>None</td>
</tr>
</tbody>
</table>

Reedsbury maintains its general fund books on a legal budgetary basis, requiring revenues and expenditures to be accounted for on a modified accrual basis. In addition, the sum of current year expenditures and encumbrances cannot exceed current year appropriations.

39. What total amount of expenditures (and encumbrances, if appropriate) should Reedsbury report in the general fund "actual" column of its combined state-
Selected Questions

2M84#46. Cura Foundation, a voluntary health and welfare organization supported by contributions from the general public, included the following costs in its statement of functional expenses for the year ended December 31, 1983:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund-raising</td>
<td>$500,000</td>
</tr>
<tr>
<td>Administrative</td>
<td>$300,000</td>
</tr>
<tr>
<td>(including data processing)</td>
<td></td>
</tr>
<tr>
<td>Research</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Cura’s functional expenses for 1983 program services included:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$900,000</td>
</tr>
<tr>
<td>b.</td>
<td>$500,000</td>
</tr>
<tr>
<td>c.</td>
<td>$300,000</td>
</tr>
<tr>
<td>d.</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

2M84#51. For the spring semester of 1984, Lane University assessed its students $3,400,000 (net of refunds), covering tuition and fees for educational and general purposes. However, only $3,000,000 was expected to be realized because scholarships totaling $300,000 were granted to students, and tuition remissions of $100,000 were allowed to faculty members' children attending Lane. How much should Lane include in educational and general current funds revenues from student tuition and fees?

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$3,400,000</td>
</tr>
<tr>
<td>b.</td>
<td>$3,300,000</td>
</tr>
<tr>
<td>c.</td>
<td>$3,100,000</td>
</tr>
<tr>
<td>d.</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

2M84#55. The following funds were among those on Kery University’s books at April 30, 1984:

- Funds to be used for acquisition of additional properties for University purposes (unexpended at 4/30/84) $3,000,000
- Funds set aside for debt service charges and for retirement of indebtedness on University properties 5,000,000

How much of the above-mentioned funds should be included in plant funds?

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$0</td>
</tr>
<tr>
<td>b.</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>c.</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>d.</td>
<td>$8,000,000</td>
</tr>
</tbody>
</table>

2M84#56. On May 1, 1984, Lila Lee established a $50,000 endowment fund, the income from which is to be paid to Waller Hospital for general operating purposes. Waller does not control the fund’s principal. Anders National Bank was appointed by Lee as trustee of this fund. What journal entry is required on Waller’s books?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Memorandum entry only</td>
<td>—</td>
</tr>
<tr>
<td>b. Nonexpendable endowment fund balance</td>
<td>$50,000</td>
</tr>
<tr>
<td>c. Cash endowment fund balance</td>
<td>50,000</td>
</tr>
<tr>
<td>d. Cash Nonexpendable endowment fund</td>
<td>50,000</td>
</tr>
</tbody>
</table>
2M82#21. Glenmore Hospital's property, plant, and equipment (net of depreciation) consists of the following:

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$500,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Movable equipment</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

What amount should be included in the restricted fund grouping?

- a. $0
- b. $2,000,000
- c. $10,500,000
- d. $12,500,000

2M82#24. During the years ended June 30, 1980 and 1981, Sonata University conducted a cancer research project financed by a $2,000,000 gift from an alumnus. This entire amount was pledged by the donor on July 10, 1979, although he paid only $500,000 at that date. The gift was restricted to the financing of this particular research project. During the two-year research period, Sonata’s related gift receipts and research expenditures were as follows:

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift receipts</td>
<td>$1,200,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Cancer research</td>
<td>900,000</td>
<td>1,100,000</td>
</tr>
</tbody>
</table>

How much gift revenue should Sonata report in the restricted column of its statement of current funds revenues, expenditures, and other changes for the year ended June 30, 1981?

- a. $0
- b. $800,000
- c. $1,100,000
- d. $2,000,000

2M82#30. During the year ended December 31, 1981, Melford Hospital received the following donations stated at their respective fair values:

- Employee services from members of a religious group: $100,000
- Medical supplies from an association of physicians. These supplies were restricted for indigent care, and were used for such purpose in 1981: $30,000

How much revenue (both operating and nonoperating) from donations should Melford report in its 1981 statement of revenues and expenses?

- a. $0
- b. $30,000
- c. $100,000
- d. $130,000

2M82#31. On January 2, 1982, John Reynolds established a $500,000 trust, the income from which is to be paid to Mansfield University for general operating purposes. The Wyndham National Bank was appointed by Reynolds as trustee of the fund. What journal entry is required on Mansfield’s books?

- a. Memorandum entry only
- b. Cash: $500,000
- c. Nonexpendable endowment fund: $500,000
- d. Expendable funds: $500,000

2M82#34. For the fall semester of 1981, Cranbrook College assessed its students $2,300,000 for tuition and fees. The net amount realized was only $2,100,000 because of the following revenue reductions:

- Refunds occasioned by class cancellations and student withdrawals: $50,000
- Tuition remissions granted to faculty members’ families: 10,000
- Scholarships and fellowships: 140,000

How much should Cranbrook report for the period for unrestricted current funds revenues from tuition and fees?

- a. $2,110,000
- b. $2,115,000
- c. $2,250,000
- d. $2,300,000

2M82#40. On July 1, 1981, Lilydale Hospital’s Board of Trustees designated $200,000 for expansion of outpatient facilities. The $200,000 is expected to be expended in the fiscal year ending June 30, 1984. In Lilydale’s balance sheet at June 30, 1982, this cash should be classified as a $200,000

- a. Restricted current asset.
- b. Restricted noncurrent asset.
- c. Unrestricted current asset.
- d. Unrestricted noncurrent asset.

AP-104
A. Inclusions for Gross Income and Adjusted Gross Income

**2M85**

Items 21 and 22 are based on the following data:

Ana and Gus Hill were granted a divorce in 1984. They had no children. In accordance with the decree, which specified that payments would cease at Ana's death, Gus made the following payments to Ana in 1984:

- Lump-sum cash settlement: $25,000
- Indefinite periodic payments: $2,100

21. How much should Ana include in her 1984 taxable income as alimony?
   a. $0
   b. $2,100
   c. $25,000
   d. $27,100

**2M85**

Items 23 and 24 are based on the following data:

Ray Birch, age 60, is single with no dependents. Birch's only income is from his occupation as a self-employed plumber. Birch owns the following assets used in his plumbing business:

<table>
<thead>
<tr>
<th>Description</th>
<th>Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land on which a storage shack is erected</td>
<td>$3,000</td>
</tr>
<tr>
<td>Shack for storage of plumbing supplies</td>
<td>12,000</td>
</tr>
</tbody>
</table>

23. Birch must file a return for 1985 if his net earnings from self-employment are at least
   a. $400
   b. $1,000
   c. $2,300
   d. $3,300

24. The capital assets used by Birch in his business amount to
   a. $0
   b. $3,000
   c. $12,000
   d. $15,000

**2M85**

Items 25 through 29 are based on the following data:

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy's mother, Cora, age 85, who earned $800 from baby sitting jobs and received $1,900 in social security benefits during 1984. Cora lives alone in her own apartment.

Emil earned a salary of $60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer's pension plan. Judy, who worked part-time in 1984 and earned $1,000, is not covered by an employer's pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life insurance proceeds on the death of an unrelated friend</td>
<td>$8,000</td>
</tr>
<tr>
<td>Interest on income tax refund</td>
<td>100</td>
</tr>
<tr>
<td>Interest on life insurance policy's accumulated dividends</td>
<td>300</td>
</tr>
<tr>
<td>Dividends on stock of a Swiss corporation</td>
<td>500</td>
</tr>
<tr>
<td>Dividend on life insurance policy</td>
<td>200</td>
</tr>
</tbody>
</table>

28. How much interest income should be reported by the Ryans in their 1984 return?
   a. $0
   b. $100
   c. $300
   d. $400

29. How much of the dividends are reportable by the Ryans in their 1984 return?
   a. $0
   b. $200
   c. $500
   d. $700

**2M85 #31.** The following information pertains to Nat Krug, a cash basis sole proprietor, for the year ended December 31, 1984:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts from business</td>
<td>$120,000</td>
</tr>
<tr>
<td>Dividend income from personal investments</td>
<td>800</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>60,000</td>
</tr>
<tr>
<td>Other business operating expenses</td>
<td>12,000</td>
</tr>
<tr>
<td>State business taxes</td>
<td>1,200</td>
</tr>
<tr>
<td>Federal self-employment tax</td>
<td>4,271</td>
</tr>
</tbody>
</table>

For the year ended December 31, 1984, how much should Krug report as net earnings from self-employment?

2M85 #32. The following information pertains to the acquisition of a six-wheel truck by Sol Barr, a self-employed contractor:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of original truck traded in</td>
<td>$20,000</td>
</tr>
<tr>
<td>Book value of original truck at trade-in date</td>
<td>4,000</td>
</tr>
<tr>
<td>List price of new truck</td>
<td>25,000</td>
</tr>
<tr>
<td>Trade-in allowance for old truck</td>
<td>6,000</td>
</tr>
<tr>
<td>Business use of both trucks</td>
<td>100%</td>
</tr>
</tbody>
</table>
Accounting Practice

A reduced regular investment tax credit was elected in lieu of reducing the basis of the new truck. The new truck will be depreciated as 3-year ACRS property. The basis of the new truck is

a. $27,000
b. $25,000
c. $23,000
d. $19,000

2N85#37. On July 1, 1980, Lila Perl paid $90,000 for 450 shares of Janis Corp. common stock. Lila received a nontaxable stock dividend of 50 new common shares in December 1981. On December 20, 1984, Lila sold the 50 new shares for $11,000. How much should Lila report in her 1984 return as long-term capital gain, before the capital gain deduction?

a. $0
b. $1,000
c. $2,000
d. $11,000

2N84#21. Mike Karp owns machinery, with an adjusted basis of $50,000, for use in his car-washing business. In addition, Karp owns his personal residence and furniture, which together cost him $100,000. The capital assets amount to

a. $0
b. $50,000
c. $100,000
d. $150,000

2N84#29. During the current year Alfred Allen sustained a serious injury in the course of his employment. As a result of this injury, Allen received the following amounts during the same year:

- Workers’ compensation $2,400
- Reimbursement from employer’s accident and health plan for medical expenses paid by Allen 1,800
- Damages for personal injuries 8,000

How much of the above amounts should Allen include in his gross income for the current year?

a. $12,200
b. $8,000
c. $1,800
d. $0

2N84

Items 30 through 33 are based on the following data:

Carl Tice, an employee of Canova Corp., received a salary of $50,000 from Canova in 1983. Also in 1983, Carl bought 100 shares of Nolan Corp. common stock from Canova for $30 a share, when the market value of the Nolan stock was $50 a share. Canova had paid $20 a share for the Nolan stock in 1975.

In addition, Carl owned a building which he leased to Boss Co. on January 1, 1983, for a five-year term at $500 a month. Boss paid Carl $8,000 in 1983 to cover the following:

- Rent for January to December 1983 $6,000
- Advance rent for January 1984 500
- Security deposit, to be applied against the final three months’ rent in the fifth year of the lease 1,500

Carl also received the following dividends in 1983, from:

- Mutual Life Insurance Co., on Carl’s life insurance policy $300
- General Merchandise Corp., a Texas corporation, on preferred stock 400
- Second National Bank, on bank’s common stock 800

On July 1, 1983, Carl sold for $9,500, on the open market, a $10,000 face value 10-year, noncallable, Doe Corp. bond. This bond was part of an original issue by Doe on July 1, 1981, and was purchased by Carl on that date, at a discount of $1,200, for a net price of $8,800.

30. How much should Carl report on his 1983 income tax return as compensation income received from Canova?

a. $50,000
b. $51,000
c. $52,000
d. $53,000

31. How much rent income should Carl report in his 1983 income tax return for the amounts paid to him by Boss?

a. $6,000
b. $6,500
c. $7,500
d. $8,000

32. Before the dividend exclusion, how much dividend income should Carl report in his 1983 income tax return?

a. $400
b. $1,100
c. $1,200
d. $1,500

33. What is Carl’s long-term capital gain in 1983, on the sale of the Doe bond?

a. $0
b. $460
c. $700
d. $1,200

2N84#37. Alex Burg, a cash basis taxpayer, earned an annual salary of $80,000 at Ace Corp. in 1983, but elected to take only $50,000. Ace, which was financially
able to pay Burg's full salary, credited the unpaid balance of $30,000 to Burg's account on the corporate books in 1983, and actually paid this $30,000 to Burg on April 30, 1984. How much of the salary is taxable to Burg in 1983?
   a. $50,000
   b. $60,000
   c. $65,000
   d. $80,000

**2M84**

**Items 22 through 28** are based on the following data:

Laura Lewis has been legally separated from her husband, Herman, since 1982. Their three-year old son, Ronald, lived with Laura for the entire year 1983. Under the written separation agreement between Laura and Herman, Herman was obligated to pay Laura $300 per month for alimony and $200 per month for child support, or a total of $6,000 annually. However, Laura received a total of only $300 from Herman during 1983. Laura's other income in 1983 was from the following sources:

<table>
<thead>
<tr>
<th>Salary</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on insurance dividends left on deposit with a life insurance company</td>
<td>100</td>
</tr>
<tr>
<td>Interest on federal income tax refund</td>
<td>60</td>
</tr>
</tbody>
</table>

In addition, Laura's father, Albert, gave Laura a gift of 500 shares of Liba Corporation common stock in 1983. Albert's basis for the Liba stock was $4,000. At the date of this gift, the fair market value of the Liba stock was $3,000.

23. How much alimony was includible in Laura's 1983 taxable income?
   a. $0
   b. $300
   c. $3,600
   d. $6,000

24. How much interest was includible in Laura's 1983 taxable income?
   a. $0
   b. $60
   c. $100
   d. $160

28. If Laura sells the 500 shares of Liba stock in 1984 for $3,500, what is the reportable gain or loss in 1984 before the long-term capital gain deduction?
   a. $3,500 gain.
   b. $500 gain.
   c. $500 loss.
   d. $0.

**2M84**

**Items 36 through 40** are based on the following data:

John Budd, who was 58 at the date of his death on July 1, 1983, received $1,000 interest in 1983 on municipal bonds. John's wife, Emma, age 57, received a $300 television set in 1983 as a gift for opening a long-term savings account at a Bank. Upon John's death, Emma received a life insurance proceeds of $60,000 under a group policy paid for by John's employer. In addition, an employee death benefit of $7,500 was paid to Emma by John's employer. A month before John died, John and Emma sold their house for $225,000. They had lived in this house since 1970 and held the property as tenants in common. Their basis for this property was $100,000. No replacement property was purchased and Emma does not intend to buy another residence. Emma did not remarry in 1983. Emma is executrix of John's estate.

37. How much taxable interest was received by John and Emma in 1983?
   a. $0
   b. $300
   c. $1,000
   d. $1,300

383#21. Don Mott was the sole proprietor of a high-volume drug store which he owned for 15 years before he sold it to Dale Drug Stores, Inc., in 1982. Besides the $900,000 selling price for the store's tangible assets and goodwill, Mott received a lump sum of $30,000 in 1982 for his agreement not to operate a competing enterprise within ten miles of the store's location, for a period of six years. The $30,000 will be taxed to Mott as
   a. $30,000 ordinary income in 1982.
   b. $30,000 short-term capital gain in 1982.
   c. $30,000 long-term capital gain in 1982.
   d. Ordinary income of $5,000 a year for six years.

383#33. In June 1982, Olive Bell bought a house for use partially as a residence and partially for operation of a retail gift shop. In addition, Olive bought the following furniture:

| Kitchen set and living room pieces for the residential portion | $ 8,000 |
| Showcases and tables for the business portion | 12,000 |

How much of this furniture comprises capital assets?
   a. $0
   b. $8,000
   c. $12,000
   d. $20,000

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2N83#36. Dr. Berger, a physician, reports on the cash basis. The following items pertain to Dr. Berger's medical practice in 1982:

- Cash received from patients in 1982 $200,000
- Cash received in 1982 from third-party reimbursers for services provided by Dr. Berger in 1981 30,000
- Salaries paid to employees in 1982 20,000
- Year-end 1982 bonuses paid to employees in 1983 1,000
- Other expenses paid in 1982 24,000

What is Dr. Berger's net income for 1982 from his medical practice?
- a. $155,000
- b. $156,000
- c. $185,000
- d. $186,000

2N83#37. Morris Babb, CPA, reports on the cash basis. In March 1983, Babb billed a client $1,000 for accounting services rendered in connection with the client's divorce settlement. No part of the $1,000 fee was ever paid. In July 1983, the client went bankrupt and the $1,000 obligation became totally worthless. What loss can Babb deduct on his 1983 tax return?
- a. $0
- b. $1,000 short-term capital loss
- c. $1,000 business bad debt
- d. $1,000 nonbusiness bad debt

2N83#38. Fred Bly, who is single and does not qualify as head of a household, had taxable income of $40,000 for 1982, exclusive of capital gains and losses. After offsetting capital gains, Bly had a net short-term capital loss of $5,000 for 1982. How much of this net short-term capital loss can Bly offset against his ordinary income for 1982?
- a. $1,000
- b. $1,500
- c. $3,000
- d. $5,000

2N83#40. Ernest Sosa files a joint return with his wife. Sosa's employer pays 100% of the cost of all employees' group-term life insurance under a qualified plan. What is the maximum amount of tax-free coverage that may be provided for Sosa by his employer under this plan?
- a. $ 5,000
- b. $10,000
- c. $50,000
- d. $100,000

1M83#41. Dr. Chester is a cash basis taxpayer. His office visit charges are usually paid on the date of visit or within one month. However, services rendered outside the office are billed weekly, and are usually paid within two months as patients collect from insurance companies. Information relating to 1982 is as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received at the time of office visits</td>
<td>$ 35,000</td>
</tr>
<tr>
<td>Collections on accounts receivable</td>
<td>130,000</td>
</tr>
<tr>
<td>Accounts receivable, January 1</td>
<td>16,000</td>
</tr>
<tr>
<td>Accounts receivable, December 31</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Dr. Chester's gross income from his medical practice for 1982 is
- a. $165,000
- b. $169,000
- c. $181,000
- d. $185,000

1M83#42. Paul Bristol, a cash basis taxpayer, owns an apartment building. The following information was available for 1982:

- An analysis of the 1982 bank deposit slips showed recurring monthly rents received totaling $50,000.
- On March 1, 1982, the tenant in apartment 2B paid Bristol $2,000 to cancel the lease expiring on December 31, 1982.
- The lease of the tenant in apartment 3A expired on December 31, 1982, and the tenant left improvements valued at $1,000. The improvements were not in lieu of any rent required to have been paid.

In computing net rental income for 1982, Bristol should report gross rents of
- a. $50,000
- b. $51,000
- c. $52,000
- d. $53,000

1M83#44. For the year 1982 Diana Clark had salary income of $38,000. In addition she had the following capital transactions during the year:

<table>
<thead>
<tr>
<th>Type of Transaction</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term capital gain</td>
<td>$14,000</td>
</tr>
<tr>
<td>Short-term capital gain</td>
<td>6,000</td>
</tr>
<tr>
<td>Long-term capital loss</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>(8,000)</td>
</tr>
</tbody>
</table>

There were no other items includible in her gross income. What is her adjusted gross income for 1982?
- a. $38,000
- b. $41,200
- c. $42,800
- d. $46,000
1MB3#45. The following information is available for Ann Drury for 1982:

Salary $36,000
Premiums paid by employer on group-term life insurance in excess of $50,000 500
Proceeds from state lottery 5,000

How much should Drury report as gross income on her 1982 tax return?

a. $36,000
b. $36,500
c. $41,000
d. $41,500

1NB2#42. In 1980, Jack Bard loaned $1,500 to his cousin, Milton, for a wedding ring. Milton gave Jack a 10% interest-bearing note for $1,500, maturing in 1982. Milton made timely interest payments on the note, but declared bankruptcy in 1982 and defaulted on the principal. What loss can Jack claim on his 1982 tax return?

a. $0
b. $1,400 casualty loss.
c. $1,500 short-term capital loss.
d. $1,500 long-term capital loss.

1NB2#47. David Hetnar is covered by a $90,000 group-term life insurance policy of which his wife is the beneficiary. Hetnar's employer pays the entire cost of the policy, for which the uniform annual premium is $8 per $1,000 of coverage. How much of this premium is taxable to Hetnar?

a. $0
b. $320
c. $360
d. $720

1NB2#50. Edward Ryan, who is single, had adjusted gross income, other than unemployment compensation, of $25,000 in 1981. Ryan had no disability income exclusion, but received $3,000 in unemployment compensation benefits during the year. How much of the unemployment compensation is taxable in 1981?

a. $0
b. $1,500
c. $2,500
d. $3,000

1MB2#41. James Harper, a self-employed individual, owned a truck driven exclusively for business use. The truck had an original cost of $8,000 and had an adjusted basis on December 31, 1980, of $3,600. On January 2, 1981, he traded it in for a new truck costing $10,000 and was given a trade-in allowance of $2,000. The new truck will also be used exclusively for business purposes and will be depreciated with no salvage value. The basis of the new truck is

a. $ 8,000
b. $ 8,400
c. $10,000
d. $11,600

1MB2#42. On July 1, 1978, William Greene paid $45,000 for 450 shares of Acme Corporation common stock. Greene received a nontaxable stock dividend of 50 new common shares in December 1979. On December 15, 1981, Greene sold the 50 new shares of common stock for $5,500. In respect of this sale Greene should report on his 1981 tax return

a. No gain or loss since the stock dividend was nontaxable.
b. $500 of long-term capital gain before capital gain deduction.
c. $1,000 of long-term capital gain before capital gain deduction.
d. $5,500 of long-term capital gain before capital gain deduction.

1MB2#47. Howard O'Brien, an employee of Ogden Corporation, died on June 30, 1981. During July Ogden made employee death payments of $10,000 to his widow, and $10,000 to his 15-year-old son. What amounts should be included in gross income by the widow and son in their respective tax returns for 1981?

<table>
<thead>
<tr>
<th>Widow</th>
<th>Son</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>$7,500</td>
<td>$7,500</td>
</tr>
</tbody>
</table>

1MB2#48. William Linnett, a cash basis sole proprietor, had the following receipts and disbursements for 1981:

<table>
<thead>
<tr>
<th>Gross receipts</th>
<th>$60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend income (on personal investment)</td>
<td>400</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>30,000</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>6,000</td>
</tr>
<tr>
<td>State business tax</td>
<td>600</td>
</tr>
<tr>
<td>Federal self-employment tax</td>
<td>1,600</td>
</tr>
</tbody>
</table>

What amount should Linnett report as net earnings from self-employment for 1981?

a. $24,000
b. $23,800
c. $23,400
d. $21,800

1MB2#58. Harold Crowe had the following capital transactions for the year 1981:

$3,000 long-term capital loss
9,000 long-term capital gain
2,000 net short-term capital gain

What is the amount of Crowe's reportable capital gain in the 1981 Schedule D summary?

a. $4,400
b. $5,200
c. $5,600
d. $7,400

AP-109
Paul Beyer, who is unmarried, has taxable income of $30,000 exclusive of capital gains and losses and his personal exemption. In 1980, Paul incurred a $1,000 net short-term capital loss and a $5,000 net long-term capital loss. His long-term capital loss carryover to 1981 is:
   a. $0
   b. $1,000
   c. $2,500
   d. $5,000

Donald Duval owns a two-family home. He rents out the first floor and resides on the second floor. The following expenses attributable to the building were incurred by Duval for the year ended December 31, 1980:

<table>
<thead>
<tr>
<th>Expenses for</th>
<th>Entire building</th>
<th>First floor</th>
<th>Second floor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>$2,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Realty taxes</td>
<td>$1,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>$1,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>$1,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Repairs</td>
<td>$300</td>
<td></td>
<td>$400</td>
</tr>
<tr>
<td>Painting</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

What portion of the expenses can Duval deduct on Schedule E of Form 1040?
   a. $1,800
   b. $3,300
   c. $6,000
   d. $6,300

During 1980, Harry Gibbs, a resident of Florida, received the following dividends:

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate investment trust</td>
<td>$1,000</td>
</tr>
<tr>
<td>Delaware corporation operating</td>
<td></td>
</tr>
<tr>
<td>exclusively in Puerto Rico</td>
<td>500</td>
</tr>
</tbody>
</table>

The total amount of gross dividends eligible for the dividend exclusion on Gibbs' 1980 federal income tax return is:
   a. $0
   b. $500
   c. $1,000
   d. $1,500

Richard and Alice Kelley lived apart during 1980 and did not file a joint tax return for the year. Under the terms of the written separation agreement they signed on July 1, 1980, Richard was required to pay Alice $1,500 per month of which $600 was designated as child support. He made six such payments in 1980. Additionally, Richard paid Alice $1,200 per month for the first six months of 1980, no portion of which was designated as child support. Assuming that Alice has no other income, her tax return for 1980 should show gross income of:
   a. $0
   b. $5,400
   c. $9,000
   d. $12,600

Henry Adams, an unmarried taxpayer, received the following amounts during 1980:
   Interest on savings accounts $1,000
   Interest on municipal bonds 500
   Dividends on General Steel common stock 750
   Dividends on life insurance policies 200

Adams should report taxable income, after exclusions, if any, from dividends and interest for 1980 in the total amount of:
   a. $1,650
   b. $1,750
   c. $1,850
   d. $2,150

Ana and Gus Hill were granted a divorce in 1984. They had no children. In accordance with the decree, which specified that payments would cease at Ana's death, Gus made the following payments to Ana in 1984:
   Lump-sum cash settlement $25,000
   Indefinite periodic payments 2,100

Gus does not itemize his deductions. How much can Gus deduct as alimony in his 1984 return?
   a. $0
   b. $2,100
   c. $25,000
   d. $27,100

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy's mother, Cora, age 85, who earned $800 from babysitting jobs and received $1,900 in social security benefits during 1984. Cora lives alone in her own apartment.

Emil earned a salary of $60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer's pension plan. Judy, who worked part-time...
Selected Questions

in 1984 and earned $1,000, is not covered by an employer's pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

Life insurance proceeds on the death of an unrelated friend $8,000
Interest on income tax refund 100
Interest on life insurance policy's accumulated dividends 300
Dividends on stock of a Swiss corporation 500
Dividend on life insurance policy 200

26. The Ryans do not itemize their deductions. How much can they contribute to IRAs in order to take advantage of their maximum allowable deduction for IRAs in their 1984 return?
   a. $0
   b. $1,000
   c. $2,250
   d. $3,000

2M84#21. Earl Cook, who worked as a machinist for Precision Corp., loaned Precision $1,000 in 1980. Cook did not own any of Precision's stock, and the loan was not a condition of Cook's employment by Precision. In 1984, Precision declared bankruptcy, and Cook's note receivable from Precision became worthless. What loss can Cook claim on his 1984 income tax return?
   a. $0
   b. $500 long-term capital loss.
   c. $1,000 short-term capital loss.
   d. $1,000 business bad debt.

2M84

28. How much could Roger deduct for the contribution to his individual retirement account in arriving at his 1983 adjusted gross income?
   a. $0
   b. $1,500
   c. $1,800
   d. $2,000

2M84#35. For the year ended December 31, 1983, Elmer Shaw earned $3,000 interest at Prestige Savings Bank, on a time savings account scheduled to mature in 1985. In January 1984, before filing his 1983 income tax return, Shaw incurred a forfeiture penalty of $1,500 for premature withdrawal of the funds from his account. Shaw should treat this $1,500 forfeiture penalty as:
   a. Penalty not deductible for tax purposes.
   b. Deduction from gross income in arriving at 1984 adjusted gross income.
   c. Deduction from 1984 adjusted gross income, deductible only if Shaw itemizes his deductions for 1984.
   d. Reduction of interest earned in 1983, so that only $1,500 of such interest is taxable on Shaw's 1983 return.

2M84

Items 36 through 40 are based on the following data:

John Budd, who was 58 at the date of his death on July 1, 1983, received $1,000 interest in 1983 on municipal bonds. John's wife, Emma, age 57, received a $300 television set in 1983 as a gift for opening a long-term savings account at a bank. Upon John's death, Emma received life insurance proceeds of $60,000 under a group policy paid for by John's employer. In addition, an employee death benefit of $7,500 was paid to Emma by John's employer. A month before John died, John and Emma sold their house for $225,000. They had lived in this house since 1970 and held the property as tenants by the entirety. Their basis for this property was $100,000. No replacement property was purchased and Emma does not intend to buy another residence. Emma did not remarry in 1983. Emma is executrix of John's estate.

38. How much of the group life insurance proceeds should be excluded from 1983 taxable income?
   a. $0
   b. $5,000
   c. $50,000
   d. $60,000

39. How much of the employee death benefit should be excluded from 1983 taxable income?
   a. $0
   b. $4,500
   c. $5,000
   d. $7,500

AP-111
40. How much of the gain on sale of the residence should be excluded from 1983 taxable income?
   a. $125,000
   b. $100,000
   c. $ 75,000
   d. $ 0

2N83#35. Mr. and Mrs. Carl Nido own 5,000 shares of common stock of Niagara Power Corporation, a qualified domestic public utility. Instead of receiving their dividends in cash on the Niagara stock, the Nidos have elected to receive common stock under Niagara's qualified dividend reinvestment plan. The Nidos earned $2,000 in dividends on their Niagara stock in 1982. What portion of these dividends could the Nidos exclude from gross dividend income (before other allowable dividend exclusions) on their 1982 joint return?
   a. $2,000
   b. $1,800
   c. $1,500
   d. $0

1M83#46. Charles Gilbert, a corporate executive, incurred business-related, unreimbursed expenses in 1982 as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entertainment</td>
<td>$900</td>
</tr>
<tr>
<td>Travel</td>
<td>700</td>
</tr>
<tr>
<td>Education</td>
<td>400</td>
</tr>
</tbody>
</table>

Assuming that Gilbert does not itemize deductions, how much of these expenses should he deduct on his 1982 tax return?
   a. $ 700
   b. $1,100
   c. $1,300
   d. $1,600

1M83#53. Mary and Robert Allen were granted a divorce in 1982. In accordance with the decree, Robert made the following payments to Mary in 1982:

<table>
<thead>
<tr>
<th>Payment Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lump-sum cash settlement</td>
<td>$20,000</td>
</tr>
<tr>
<td>Indefinite periodic payments</td>
<td>12,000</td>
</tr>
</tbody>
</table>

How much of the payments should Robert deduct in arriving at his adjusted gross income for 1982?
   a. $0
   b. $12,000
   c. $20,000
   d. $32,000

1N82#44. Daniel Kelly received interest income from the following sources in 1981:

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York Port Authority bonds</td>
<td>$1,000</td>
</tr>
<tr>
<td>Puerto Rico Commonwealth bonds</td>
<td>1,800</td>
</tr>
</tbody>
</table>

What portion of such interest is tax exempt?
   a. $0
   b. $1,000
   c. $1,800
   d. $2,800

1N82#45. Martin Dawson, who resided in Detroit, was unemployed for the last six months of 1981. In January 1982, he moved to Houston to seek employment, and obtained a full-time job there in February. He kept this job for the balance of the year. Martin paid the following expenses in 1982 in connection with his move:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental of truck to move his personal belongings to Houston</td>
<td>$ 800</td>
</tr>
<tr>
<td>Penalty for breaking the lease on his Detroit apartment</td>
<td>300</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,100</strong></td>
</tr>
</tbody>
</table>

How much can Martin deduct in 1982 for moving expenses?
   a. $0
   b. $300
   c. $800
   d. $1,100

1N82#48. Lila Lux retired on December 31, 1980, with a monthly pension of $300. Her contributions to the pension plan totaled $6,000, while her employer's contributions to the plan totaled $12,000. How much of the pension is taxable in 1981?
   a. $0
   b. $1,800
   c. $2,400
   d. $3,600

1N82#58. Ronald Birch, who is single, earned a salary of $30,000 in 1982 as a plumber employed by Lupo Company. Birch was covered for the entire year 1982 under Lupo's qualified pension plan for employees. In addition, Birch had a net income of $10,000 from self-employment in 1982. What is the maximum amount that Birch can deduct in 1982 for contributions to an individual retirement account (IRA)?
   a. $4,500
   b. $2,000
   c. $1,500
   d. $0

1M82#49. Herbert Mann is an engineer employed by a major chemical company. During 1981 he paid the following business related expenses:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Travel expenses incurred while away from home overnight</td>
<td>$2,500</td>
</tr>
<tr>
<td>Executive search consultant fees paid in securing a new job in same profession</td>
<td>1,500</td>
</tr>
<tr>
<td>Professional society dues</td>
<td>600</td>
</tr>
<tr>
<td>Transportation expenses</td>
<td>350</td>
</tr>
</tbody>
</table>
Selected Questions

Mann received travel expense reimbursements totaling $2,300 from his employer during 1981. How much should Mann deduct as employee business expenses in arriving at his adjusted gross income for 1981?
   a. $ 550  
   b. $2,050  
   c. $2,650  
   d. $2,850

2N81#46. Richard Putney, who lived in Idaho for five years, moved to Texas in 1980 to accept a new position. His employer reimbursed him in full for all direct moving costs, but did not pay for any part of the following indirect moving expenses incurred by Putney:

   Househunting trips to Texas $800  
   Temporary housing in Texas   900

How much of the indirect expenses can be deducted by Putney as moving expenses?
   a. $0  
   b. $ 900  
   c. $1,500  
   d. $1,700

2N81#60. Martin Kohl, who is 67 years old, was permanently and totally disabled when he retired in 1976. He has been receiving disability payments in lieu of wages since his retirement. In 1980, such payments amounted to $6,200. Kohl also had $10,800 of other income. Kohl’s maximum disability income exclusion for 1980 is
   a. $0  
   b. $3,200  
   c. $4,600  
   d. $5,200

1M81#46. Frank Clarke, an employee of Smithson Company, was covered under a noncontributory pension plan. Frank died on April 15, 1980, at age 64 and pursuant to the plan, his widow received monthly pension payments of $500 beginning May 1, 1980. In addition Mrs. Clarke received an employee death payment of $10,000 in May 1980. What is the total amount of the above receipts that the widow should exclude from her gross income for 1980?
   a. $ 5,000  
   b. $ 9,000  
   c. $10,000  
   d. $14,000

1M81#60. Roger Burrows, age 19, is a full-time student at Marshall College and a candidate for a bachelor’s degree. During 1980 he received the following payments:

   State scholarship for ten months $3,600  
   Loan from college financial aid office   1,500  
   Cash support from parents   3,000  
   Cash dividends on qualified investments   700  
   Cash prize awarded in contest   500

What is Burrows’s adjusted gross income for 1980?
   a. $1,100  
   b. $1,200  
   c. $4,800  
   d. $9,300

C. Gain or Loss on Property Transactions

2M85

Items 38 through 40 are based on the following data:

On July 1, 1984, Kim Wald sold an antique for $15,000 that she had bought for her personal use in 1981 at a cost of $12,000. Also on July 1, 1984, Kim sold 100 shares of Ral Corp. stock. Kim had received this stock on March 1, 1984, as a bequest from the estate of John Wolf who died on January 2, 1984, when this stock had a fair market value of $8,000. The executor of John’s estate did not elect the alternate valuation. John had bought this stock in 1970 for $1,000.

38. In her 1984 return, Kim should treat the sale of the antique as a transaction resulting in
   a. No taxable gain.  
   b. Ordinary income.  
   c. Short-term capital gain.  
   d. Long-term capital gain.

40. Kim’s holding period for the 100 shares of Ral stock was
   a. Long-term.  
   b. Short-term.  
   c. Long-term if sold at a gain; short-term if sold at a loss.  
   d. Short-term if sold at a gain; long-term if sold at a loss.

2N84

Items 34 through 36 are based on the following data:

On March 1, 1983, Lois Rice learned that she was bequeathed 1,000 shares of Elin Corp. common stock under the will of her uncle, Pat Prevor. Pat had paid $5,000 for the Elin stock in 1980. Fair market value of the Elin stock on March 1, 1983, the date of Pat’s death, was $8,000 and had increased to $11,000 six months later. The executor of Pat’s estate elected the alternative valuation date for estate tax purposes. Lois sold the Elin stock for $9,000 on May 1, 1983, the date that the executor distributed the stock to her.

35. Lois’ basis for gain or loss on sale of the 1,000 shares of Elin stock is
   a. $ 5,000  
   b. $ 8,000  
   c. $ 9,600  
   d. $11,000

AP-113
36. Lois should treat the 1,000 shares of Elin stock as a
   a. Short-term Section 1231 asset.
   b. Long-term Section 1231 asset.
   c. Short-term capital asset.
   d. Long-term capital asset.

2N84#40. On July 1, 1984, Louis Herr exchanged an office building having a fair market value of $400,000, for cash of $80,000 plus an apartment building having a fair market value of $320,000. Herr's adjusted basis for the office building was $250,000. How much gain should Herr recognize in his 1984 income tax return?
   a. $0
   b. $80,000
   c. $150,000
   d. $330,000

2N83#39. An office building owned by Elmer Bass was condemned by the state on January 2, 1982. Bass received the condemnation award on March 1, 1983. In order to qualify for nonrecognition of gain on this involuntary conversion, what is the last date for Bass to acquire qualified replacement property?
   c. March 1, 1986.

1M83#47. On July 1, 1982, Riley exchanged investment real property, with an adjusted basis of $160,000 and subject to a mortgage of $70,000, and received from Wilson $30,000 cash and other investment real property having a fair market value of $250,000. Wilson assumed the mortgage. What is Riley's recognized gain in 1982 on the exchange?
   a. $30,000
   b. $70,000
   c. $90,000
   d. $100,000

2N82#41. Robert Efron owned an apartment house that he bought in 1970. Depreciation was taken on a straight-line basis. In 1982, when Efron's adjusted basis for this property was $100,000, he traded it for an office building having a fair market value of $300,000. The apartment house has 100 dwelling units, while the office building has 50 units rented to business enterprises. The properties are not located in the same city. What is Efron's reportable gain on this exchange?
   a. $0
   b. $200,000 long-term capital gain.
   c. $200,000 Section 1231 gain.
   d. $200,000 Section 1250 gain.

1M81#43. On July 1, 1980, Thomas Rich acquired certain stocks with a fair market value of $22,000 by gift from his father. The stocks had been acquired by the father on April 1, 1978, at a cost of $40,000. Thomas sold all the stocks for $28,000 on December 12, 1980. What amount should Thomas report as capital gain or loss on his 1980 tax return as a result of the above?
   a. $0.
   b. $2400 gain.
   c. $6000 gain.
   d. $12000 loss.

D. Deductions From Adjusted Gross Income

2M85
Items 33 through 36 are based on the following data:

Bart Sheen, who is single, itemizes his deductions. The following were among Bart's cash expenditures during 1984:

- Interest on bank loan to purchase taxable securities: $1,000
- Finance charges on a revolving charge account at a department store, based on monthly unpaid balances: $400
- Fourth quarter 1983 estimated state income tax: $1,200
- City real estate taxes on property owned by Bart and leased to a tenant: $3,000
- Charitable contributions: $5,000
- Contribution to candidate for public office: $200

34. How much interest expense should Bart include in his schedule of itemized deductions for 1984?
   a. $0
   b. $400
   c. $1,000
   d. $1,400

35. How much should Bart include as taxes in his schedule of itemized deductions for 1984?
   a. $0
   b. $1,200
   c. $3,000
   d. $4,200

2N84
Items 22 through 26 are based on the following data:

Eric Ross, who is single and has no dependents, had an adjusted gross income of $80,000 in 1983, comprised of the following:

Salary: $74,000
Net investment income: $6,000

During 1983, uninsured art objects owned by Eric, with a basis of $50,000 and a fair market value of $70,000,
sustained casualty fire damage reducing the fair market value of $60,000. Also during 1983, Eric made the following payments:

Interest on margin account at stockbroker $18,000
Real estate taxes on condominium owned by Eric's mother, in which Eric resides 3,000
State and city gasoline taxes 180
Medical insurance premiums 300
Unreimbursed dental expenses 4,500
Contribution to political committee of elected public official 500

Eric elected to itemize his deductions for 1983.

22. How much can Eric claim in his itemized deductions for interest on his 1983 return?
   a. $6,000
   b. $12,000
   c. $16,000
   d. $18,000

23. How much can Eric claim as taxes in itemized deductions on his 1983 return?
   a. $0
   b. $180
   c. $3,000
   d. $3,180

24. How much can Eric claim in his itemized deductions for medical and dental expenses on his 1983 return?
   a. $2,400
   b. $800
   c. $300
   d. $150

25. How much can Eric claim in his itemized deductions for the casualty loss on his 1983 return?
   a. $0
   b. $1,900
   c. $2,000
   d. $9,900

2N84#28. Dan Barlow, who itemizes his deductions, had an adjusted gross income of $70,000 in 1983. The following additional information is available for 1983:

   Cash contribution to church $5,000
   Purchase of art object at church bazaar (with a fair market value of $1,000 on the date of purchase) 1,600
   Donation of used clothing to Salvation Army (fair value evidenced by receipt received) 800

What is the maximum amount Barlow can claim as a deduction for charitable contributions in 1983?
   a. $5,600
   b. $6,400
   c. $6,600
   d. $6,800

2N84

Items 29 through 34 are based on the following data:

Roger Efron, who is single and has no dependents, earned a salary of $50,000 in 1983, and had an adjusted gross income of $60,000. Roger has been an active participant in a qualified noncontributory pension plan since 1972. Roger itemized his deductions on his 1983 income tax return. Among Roger's 1983 cash expenditures were the following:

Real estate taxes on Roger's condominium $4,000
Contribution to an individual retirement account ($200 interest was earned on this IRA in 1983) 2,000
Dental expenses 700
Premium on Roger's life insurance policy 600
Medical insurance premiums 500
Contribution to candidate for public office 300
Legal fee for preparation of Roger's will 200
Customs duties 80
City dog license fee 10

In addition, Roger suffered a casualty loss of $400 in 1983 due to storm damage.

30. How much could Roger deduct in 1983 for medical and dental expenses?
   a. $0
   b. $150
   c. $700
   d. $1,200

31. How much could Roger deduct in 1983 for taxes?
   a. $4,000
   b. $4,010
   c. $4,080
   d. $4,090

32. How much could Roger deduct in 1983 for miscellaneous deductions?
   a. $0
   b. $200
   c. $600
   d. $800
Accounting Practice

33. How much could Roger deduct in 1983 for the casualty loss?
   a. $0
   b. $100
   c. $300
   d. $400

2N83

Items 30 and 31 are based on the following data:

Frank Lyon, who itemized his deductions on his 1982 income tax return, paid the following unreimbursed expenses in 1982:

- Realty taxes on the house in which he resides with his dependent mother; the house is owned by his mother: $3,000
- State and city gasoline taxes: $100
- Physical examination required by Frank’s employer: $200
- Meals in connection with overtime work: $180

In addition, Frank was held up and robbed of $800 cash in June 1982. One month later, Frank had $2,000 cash stolen from him by his housekeeper.

30. How much of the realty and gasoline taxes should be included in Frank’s itemized deductions in 1982?
   a. $0
   b. $100
   c. $3,000
   d. $3,100

31. How much was deductible by Frank as employee business expenses for 1982?
   a. $0
   b. $180
   c. $200
   d. $380

1M83#49. William Dalton, age 30 and single, provided the following information for his 1982 income tax return:

- Salary: $30,000
- Payment to an Individual Retirement Account: $2,000
- Total itemized deductions: $3,400
- Number of exemptions claimed: 1

Dalton should report taxable income for 1982 of
   a. $24,600
   b. $25,900
   c. $26,900
   d. $27,900

1M83#50. Robert and Judy Parker made the following payments during 1982:

- Interest on a life insurance policy loan (the related policy on Robert’s life was purchased in 1950): $1,200
- Interest on home mortgage for period January 1 to October 4, 1982: $3,600
- Penalty payment for prepayment of home mortgage on October 4, 1982: $900

How much can the Parkers utilize as interest expense in calculating excess itemized deductions for 1982?
   a. $5,700
   b. $4,800
   c. $4,500
   d. $3,600

1M83#51. Henry Warren did not itemize his deductions on his 1981 and 1980 federal income tax returns. However, Warren plans to itemize his deductions for 1982. The following information relating to his state income taxes is available:

- Taxes withheld in 1982: $2,000
- Refund received in 1982 of 1981 tax: $300
- Assessment paid in 1982 of 1980 tax: $200

What amount should Warren utilize as state and local income taxes in calculating excess itemized deductions for his 1982 federal income tax return?
   a. $1,700
   b. $1,900
   c. $2,000
   d. $2,200

1M83#52. Ruth Lewis has adjusted gross income of $100,000 for 1982 and itemizes her deductions. On September 1, 1982, she made a contribution to her church of stock held for investment for two years which cost $10,000 and had a fair market value of $70,000. The church sold the stock for $70,000 on the same date. Assume that Lewis made no other contributions during 1982 and made no special election in regard to this contribution on her 1982 tax return. How much should Lewis claim as a charitable contribution deduction for 1982?
   a. $50,000
   b. $30,000
   c. $20,000
   d. $10,000

1N82#51. Sara Harding is a cash basis taxpayer who itemizes her deductions. The following information pertains to Sara’s state income taxes for the taxable year 1981:
Selected Questions

Withheld by employer in 1981 $2,000

Payments on 1981 estimate:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/15/81</td>
<td>$300</td>
</tr>
<tr>
<td>6/15/81</td>
<td>300</td>
</tr>
<tr>
<td>9/15/81</td>
<td>300</td>
</tr>
<tr>
<td>1/15/82</td>
<td>1,200</td>
</tr>
</tbody>
</table>

Total paid and withheld $3,200
Actual tax, per state return 3,000
Overpayment $200

There was no balance of tax or refund due on Sara’s 1980 state tax return. How much is deductible for state income taxes on Sara’s 1981 federal income tax return?

1MA2#52. On December 15, 1981, Donald Calder made a contribution of $500 to a qualified charitable organization, by charging the contribution on his bank credit card. Calder paid the $500 on January 20, 1982, upon receipt of the bill from the bank. In addition, Calder issued and delivered a promissory note for $1,000 to another qualified charitable organization on November 1, 1981, which he paid upon maturity six months later. If Calder itemizes his deductions, what portion of these contributions is deductible in 1981?

1MA2#51. Charles Wolfe purchased the following long-term investments at par during 1981:

- $20,000 general obligation bonds of Burlington County (wholly tax exempt)
- $10,000 debentures of Arrow Corporation

Wolfe financed these purchases by obtaining a $30,000 loan from the Union National Bank. For the year 1981, Wolfe made the following interest payments:

- Union National Bank $3,600
- Interest on home mortgage 3,000
- Interest on credit card charges 500

What amount can Wolfe utilize as interest expense in calculating excess itemized deductions for 1981?

1MA2#52. During 1981 Jack and Mary Bronson paid the following taxes:

Taxes on residence (for period January 1 to September 30, 1981) $2,700
State motor vehicle tax on value of the car 360
The Bronsons sold their house on June 30, 1981, under an agreement in which the real estate taxes were not prorated between the buyer and sellers. What amount should the Bronsons deduct as taxes in calculating excess itemized deductions for 1981?

1MA2#54. The following information is available for Seymour and Ruth Atkinson, who reside in Pennsylvania, for 1981:

- Adjusted gross income $31,500
- Tax-exempt interest received $1,500

Exemptions (including exemption claimed for their son John, a full-time student at State University) 3

An abstract from the Optional Sales Tax Table for Pennsylvania is presented below:

<table>
<thead>
<tr>
<th>Income</th>
<th>Family size</th>
<th>Family size</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30,001-$32,000</td>
<td>$219</td>
<td>$248</td>
</tr>
<tr>
<td>$32,001-$34,000</td>
<td>$230</td>
<td>$261</td>
</tr>
</tbody>
</table>

Assuming that the Atkinsons elect to use the Optional Sales Tax Table, what is the maximum amount of general sales taxes that they can utilize in calculating excess itemized deductions for 1981?

1MA2#55. Frank Lanier is a resident of a state that imposes a tax on income. The following information pertaining to Lanier’s state income taxes is available:

- Taxes withheld in 1981 $3,500
- Refund received in 1981 of 1980 tax 400
- Deficiency assessed and paid in 1981 for 1979:
  - Tax 600
  - Interest 100

What amount should Lanier utilize as state and local income taxes in calculating excess itemized deductions for his 1981 federal tax return?
Items 47 and 48 are based on the following data: Donald Duval owns a two-family home. He rents out the first floor and resides on the second floor. The following expenses attributable to the building were incurred by Duval for the year ended December 31, 1980:

<table>
<thead>
<tr>
<th>Expenses for</th>
<th>Entire building</th>
<th>First floor</th>
<th>Second floor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>$2,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Realty taxes</td>
<td>1,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>1,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>1,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Repairs</td>
<td></td>
<td>$300</td>
<td></td>
</tr>
<tr>
<td>Painting</td>
<td></td>
<td></td>
<td>$400</td>
</tr>
</tbody>
</table>

48. What portion of the expenses can Duval take as itemized deductions on Schedule A of Form 1040? 
   a. $1,500  
   b. $1,900  
   c. $3,400  
   d. $6,400

Mr. and Mrs. Donald Curry's real property tax year is on a calendar-year basis, with payment due annually on August 1. The realty taxes on their home amounted to $1,200 in 1981, but the Currys did not pay any portion of that amount since they sold the house on April 1, 1981, four months before payment was due. However, realty taxes were prorated on the closing statement. Assuming that they owned no other real property during the year, how much can the Currys deduct on Schedule A of Form 1040 for real estate taxes in 1981? 
   a. $0  
   b. $296  
   c. $697  
   d. $1,200

Magda Micale, a public school teacher, paid the following items in 1980, for which she received no reimbursement:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initiation fee for membership in teachers’ union</td>
<td>$100</td>
</tr>
<tr>
<td>Dues to teachers’ union</td>
<td>180</td>
</tr>
<tr>
<td>Voluntary unemployment benefit fund contributions to union-established fund</td>
<td>72</td>
</tr>
</tbody>
</table>

How much can Magda claim in 1980 as allowable miscellaneous deductions on Schedule A of Form 1040? 
   a. $180  
   b. $280  
   c. $252  
   d. $352

Gabriel Colon, a jet airplane mechanic, paid the following items in 1980, for which he received no reimbursement:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tools used in connection with his work</td>
<td>$600</td>
</tr>
<tr>
<td>(bought on July 1, 1980; estimated useful life 5 years; no salvage value)</td>
<td></td>
</tr>
<tr>
<td>Union dues</td>
<td>$180</td>
</tr>
<tr>
<td>Legal fee in connection with preparation of his will, 25% of which was attributable to income tax advice</td>
<td>$300</td>
</tr>
</tbody>
</table>

How much can Colon claim in 1980 as allowable miscellaneous deductions on Schedule A of Form 1040?
   a. $315  
   b. $780  
   c. $855  
   d. $1,080

   a. $353  
   b. $700  
   c. $953  
   d. $1,300

Phil and Joan Crawley made the following payments during 1980:

<table>
<thead>
<tr>
<th>Payment</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on bank loan (loan proceeds were used to purchase United States savings bonds Series II)</td>
<td>$4,000</td>
</tr>
<tr>
<td>Interest on installment charge accounts</td>
<td>500</td>
</tr>
<tr>
<td>Interest on home mortgage for period April 1 to December 31, 1980</td>
<td>2,700</td>
</tr>
<tr>
<td>Points paid to obtain conventional mortgage loan on April 1, 1980</td>
<td>900</td>
</tr>
</tbody>
</table>

What is the maximum amount that the Crawleys can utilize as interest expense in calculating excess itemized deductions for 1980? 
   a. $4,100  
   b. $7,200  
   c. $7,600  
   d. $8,100

Don and Cynthia Wallace filed a joint return for 1980 in which they reported adjusted gross income of $35,000. During 1980 they made the following contributions to qualified organizations:

<table>
<thead>
<tr>
<th>Contribution</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land (stated at its current fair market value) donated to church for new building site</td>
<td>$22,000</td>
</tr>
<tr>
<td>Cash contributions to church</td>
<td>300</td>
</tr>
<tr>
<td>Cash contributions to the local community college</td>
<td>200</td>
</tr>
</tbody>
</table>
Selected Questions

Assuming that the Wallaces did not elect to reduce the deductible amount of the land contribution by 40% of the property's appreciation in value, how much can they claim as a deduction for charitable contributions in 1980?

a. $10,800
b. $11,000
c. $17,500
d. $22,500

1M81#54. Jon and Connie Cooke, who are filing a joint return for 1980, elect to use the Optional Sales Tax Table which allows them to deduct general sales taxes of $400 based on their gross income and family size. During 1980 they paid general sales taxes on the following large purchases:

<table>
<thead>
<tr>
<th>General sales</th>
<th>taxes paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase of a new car for $8,500</td>
<td>$510</td>
</tr>
<tr>
<td>Purchase of wearing apparel during year totaling $3,000</td>
<td>180</td>
</tr>
</tbody>
</table>

What is the maximum amount of general sales taxes that the Cookes can utilize in calculating excess itemized deductions for 1980?

a. $400
b. $580
c. $910
d. $1,090

1M81#57. During 1980 Mr. and Mrs. West paid the following taxes:

Property taxes on residence | $1,800
Special assessment for installation of a sewer system in their town | 1,000
State personal property tax on their automobile | 600
Property taxes on land held for long-term appreciation | 300

What amount can the Wests deduct as property taxes in calculating excess itemized deductions for 1980?

a. $2,100
b. $2,700
c. $3,100
d. $3,700

E. Filing Status and Exemptions

2M85

Items 25 through 29 are based on the following data:

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy's mother, Cora, age 85, who earned $800 from babysitting jobs and received $1,900 in social security benefits during 1984. Cora lives alone in her own apartment.

Emil earned a salary of $60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer's pension plan. Judy, who worked part-time in 1984 and earned $1,000, is not covered by an employer's pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

- Life insurance proceeds on the death of an unrelated friend: $8,000
- Interest on income tax refund: 100
- Interest on life insurance policy's accumulated dividends: 300
- Dividends on stock of a Swiss corporation: 500
- Dividend on life insurance policy: 200

25. How many exemptions should be claimed by the Ryans for 1984?

a. Two
b. Three
c. Four
d. Five

2M85#30. Sara Hance, who is single and lives alone in Idaho, has no income of her own and is supported in full by the following persons:

<table>
<thead>
<tr>
<th>Amount of support</th>
<th>Percent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alma (an unrelated friend)</td>
<td>$2,400</td>
</tr>
<tr>
<td>Ben (Sara's brother)</td>
<td>2,150</td>
</tr>
<tr>
<td>Carl (Sara's son)</td>
<td>450</td>
</tr>
<tr>
<td><strong>$5,000</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Under a multiple support agreement, Sara's dependency exemption can be claimed by

a. No one.
b. Alma.
c. Ben.
d. Carl.

2M84

Items 22 through 28 are based on the following data:

Laura Lewis has been legally separated from her husband, Herman, since 1982. Their three-year-old son, Ronald, lived with Laura for the entire year 1983. Under the written separation agreement between Laura and Herman, Herman was obligated to pay Laura $300 per month for alimony and $200 per month for child support, or a total of $6,000 annually. However, Laura
received a total of only $300 from Herman during 1983. Laura's other income in 1983 was from the following sources:

Salary $20,000
Interest on insurance dividends $2,250
left on deposit with a life insurance company $100
Interest on federal income tax refund $60

In addition, Laura's father, Albert, gave Laura a gift of 500 shares of Liba Corporation common stock in 1983. Albert's basis for the Liba stock was $4,000. At the date of this gift, the fair market value of the Liba stock was $3,000.

22. What was Laura's filing status for 1983?
   a. Single.
   b. Married filing separate return.
   c. Unmarried head of household.
   d. Married head of household.

2M84
Items 36 through 40 are based on the following data:

John Budd, who was 58 at the date of his death on July 1, 1983, received $1,000 interest in 1983 on municipal bonds. John's wife, Emma, age 57, received a $300 television set in 1983 as a gift for opening a long-term savings account at a bank. Upon John's death, Emma received life insurance proceeds of $60,000 under a group policy paid for by John's employer. In addition, an employee death benefit of $7,500 was paid to Emma by John's employer. A month before John died, John and Emma sold their house for $225,000. They had lived in this house since 1970 and held the property as tenants by the entirety. Their basis for this property was $100,000. No replacement property was purchased and Emma does not intend to buy another residence. Emma did not remarry in 1983. Emma is executrix of John's estate.

36. With regard to John's and Emma's filing status for 1983, Emma should file
   a. As a single individual, and a separate return should be filed for John as unmarried head of household.
   b. As a qualifying widow, and a separate return should be filed for John as married head of household.
   c. As a qualifying widow, and a separate return should be filed for John as a single deceased individual.
   d. A joint return including John, as married taxpayers.

2N83#23. Alex Kerr was 65 years old on January 21, 1983, and has been legally blind for the past three years. Alex's wife, Rose, lived with him until her death on January 5, 1982, at the age of 50. Rose had no income of her own. Alex did not remarry in 1982. How many personal exemptions was Alex entitled to on his 1982 income tax return?
   a. One
   b. Two
   c. Three
   d. Four

2N83#24. Jill Nolan's filing status for 1982 was that of a single individual. Jill claimed itemized deductions of $5,000 on her 1982 income tax return. How much was Jill's zero bracket amount for 1982?
   a. $1,700
   b. $2,300
   c. $2,700
   d. $3,400

1M83#56. During 1982 Robert Moore, who is 50 years old and unmarried, maintained his home in which he and his widower father, age 75, resided. His father had $1,600 interest income from a savings account and also received $2,400 from social security during 1982. Robert provided 60% of his father's total support for 1982. What is Robert's filing status for 1982, and how many exemptions should he claim on his tax return?
   a. Head of household and 2 exemptions.
   b. Single and 2 exemptions.
   c. Head of household and 1 exemption.
   d. Single and 1 exemption.

1M83#57. During 1982 Mary Dunn provided 20% of her own support; the remaining 80% was provided by her three sons as follows:

<table>
<thead>
<tr>
<th>Son</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bill</td>
<td>15%</td>
</tr>
<tr>
<td>Jon</td>
<td>25%</td>
</tr>
<tr>
<td>Tom</td>
<td>40%</td>
</tr>
<tr>
<td></td>
<td>80%</td>
</tr>
</tbody>
</table>

Assume that a multiple support agreement exists and that the brothers will sign multiple support declarations as required. Which of the brothers is eligible to claim the mother as a dependent for 1982?
   a. None of the brothers.
   b. Tom only.
   c. Jon or Tom only.
   d. Bill, Jon or Tom.

1M83#58. John and Mary Arnold are a childless, married couple who lived apart (alone in homes maintained by each) the entire year 1982. On December 31, 1982, they were legally separated under a decree of separate maintenance. Which of the following is the only filing status choice available to them when filing for 1982?
   a. Single.
   b. Head of household.
   c. Married filing separate return.
   d. Married filing joint return.
**Selected Questions**

1M82#43. During 1981 Murray Richman, who is 60 years old and unmarried, was the sole support of his aged mother. His mother was a resident of a home for the aged for the entire year and had no income. What is Richman’s filing status for 1981, and how many exemptions should he claim on his tax return?
   a. Head of household and 2 exemptions.
   b. Single and 2 exemptions.
   c. Head of household and 1 exemption.
   d. Single and 1 exemption.

1M82#60. Mark Erickson, age 46, filed a joint return for 1981 with his wife Helen, age 24. Their son John was born on December 16, 1981. Mark provided 60% of the support of his 72-year-old widowed mother until April 10, 1981, when she died. His mother’s only income was from social security benefits totaling $1,100 during 1981. How many exemptions should the Ericksons claim on their 1981 tax return?
   a. 2
   b. 3
   c. 4
   d. 5

1M81#44. During 1980 Howard Thomson maintained his home in which he and his sixteen-year-old son resided. The son qualifies as his dependent. Thomson’s wife died in 1979, for which year a joint return was appropriately filed. Thomson remarried on March 15, 1981. What is Thomson’s filing status for 1980?
   a. Single.
   b. Head of household.
   c. Surviving spouse.
   d. Married filing jointly.

1M81#55. Albert and Lois Stoner, age 66 and 64, respectively, filed a joint tax return for 1980. They provided all of the support for their blind 19-year-old son, who has no gross income. Their 23-year-old daughter, a full-time student until her graduation on June 14, 1980, earned $2,000, which was 40% of her total support during 1980. Her parents provided the remaining support. The Stoners also provided the total support of Lois’ father, who is a citizen and lifelong resident of Peru. How many exemptions can the Stoners claim on their 1980 income tax return?
   a. 4
   b. 5
   c. 6
   d. 7

**F. Tax Computations and Credits**

2M85

Items 33 through 36 are based on the following data:

Bart Sheen, who is single, itemizes his deductions. The following were among Bart’s cash expenditures during 1984:

- Interest on bank loan to purchase taxable securities: $1,000
- Finance charges on a revolving charge account at a department store, based on monthly unpaid balances: 400
- Fourth quarter 1983 estimated state income tax: 1,200
- City real estate taxes on property owned by Bart and leased to a tenant: 3,000
- Charitable contributions: 5,000
- Contribution to candidate for public office: 200

36. How much should Bart include for political contributions in his schedule of itemized deductions for 1984?
   a. $0
   b. $50
   c. $100
   d. $200

2N84

Items 22 through 26 are based on the following data:

Eric Ross, who is single and has no dependents, had an adjusted gross income of $80,000 in 1983, comprised of the following:

- Salary: $74,000
- Net investment income: 6,000

During 1983, uninsured art objects owned by Eric, with a basis of $50,000 and a fair market value of $70,000, sustained casualty fire damage reducing the fair market value to $60,000. Also during 1983, Eric made the following payments:

- Interest on margin account at stockbroker: $18,000
- Real estate taxes on condominium owned by Eric’s mother, in which Eric resides: 3,000
- State and city gasoline taxes: 180
- Medical insurance premiums: 300
- Unreimbursed dental expenses: 4,500
- Contribution to political committee of elected public official: 500

Eric elected to itemize his deductions for 1983.

26. How much of a tax credit can Eric claim on his 1983 return for the $500 political contribution?
   a. $250
   b. $100
   c. $50
   d. $0
Items 29 through 34 are based on the following data:

Roger Efron, who is single and has no dependents, earned a salary of $50,000 in 1983, and had an adjusted gross income of $60,000. Roger has been an active participant in a qualified noncontributory pension plan since 1972. Roger itemized his deductions on his 1983 income tax return. Among Roger’s 1983 cash expenditures were the following:

- Real estate taxes on Roger’s condominium: $4,000
- Contribution to an individual retirement account (200 interest earned on this IRA in 1983): 2,000
- Dental expenses: 700
- Premium on Roger’s life insurance policy: 600
- Medical insurance premiums: 500
- Contribution to candidate for public office: 300
- Legal fee for preparation of Roger’s will: 200
- Customs duties: 80
- City dog license fee: 10

In addition, Roger suffered a casualty loss of $400 in 1983 due to storm damage.

34. How much of a credit could Roger offset against his 1983 income tax, for his contribution to a candidate for public office?
   a. $0
   b. $50
   c. $100
   d. $150

One of the requirements for claiming the earned income credit is that the individual’s:
   a. Earned income must be $10,000 or more.
   b. Earned income must be $10,000 or less.
   c. Adjusted gross income must be less than $10,000.
   d. Adjusted gross income must be equal to earned income.

Nora Hayes, a widow, maintains a home for herself and her two dependent preschool children. In 1982, Nora’s earned income and adjusted gross income was $29,000. During 1982, Nora paid work-related expenses of $3,000 for a housekeeper to care for her children. How much can Nora claim for child care credit in 1982?
   a. $0
   b. $480
   c. $600
   d. $900

Philip and Joan Sampson, filing a joint tax return for 1981, had a tax liability of $8,000 computed from the tax table. During 1981 Philip contributed $150 to a candidate for a local elective public office. Assuming that the Sampsons do not claim any other credits against their tax, what is the amount of the political contributions tax credit they should claim on their tax return for 1981?
   a. $150
   b. $100
   c. $75
   d. $50

In 1980, Alex Burgos paid $600 to Rita, his ex-wife, for child support. Under the terms of the divorce decree, Alex claims the exemption for his five-year-old son, William, who lived with Rita for the entire year. Alex’s only income in 1980 was from wages of $5,500, resulting in an income tax of $172. How much is Alex’s earned income credit for 1980?
   a. $0
   b. $328
   c. $378
   d. $500

Melvin Crane is 66 years old, and his wife, Matilda, is 65. They filed a joint income tax return for 1980, reporting an adjusted gross income of $7,800, on which they paid a tax of $60. They received $1,250 from social security benefits in 1980. How much can they claim on Schedule R of Form 1040 in 1980, as a credit for the elderly?
   a. $0
   b. $60
   c. $315
   d. $375

G. Statute of Limitations

Ronald Raff filed his 1983 individual income tax return on January 15, 1984. There was no underatement of income on the return, and the return was properly signed and filed. The statute of limitations for Raff’s 1983 return expires on:
   d. April 15, 1990.

H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

Items 25 through 29 are based on the following data:

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy’s mother, Cora, age 85, who earned $800 from baby sitting jobs and received $1,900 in social security benefits during 1984. Cora lives alone in her own apartment.
Emil earned a salary of $60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer’s pension plan. Judy, who worked part-time in 1984 and earned $1,000, is not covered by an employer’s pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

- Life insurance proceeds on the death of an unrelated friend: $8,000
- Interest on income tax refund: 100
- Interest on life insurance policy’s accumulated dividends: 300
- Dividends on stock of a Swiss corporation: 500
- Dividend on life insurance policy: 200

27. How much of the life insurance proceeds should be reported by the Ryans in their 1984 return?
   a. $0
   b. $3,000
   c. $5,000
   d. $8,000

2M85

Items 38 through 40 are based on the following data:

On July 1, 1984, Kim Wald sold an antique for $15,000 that she had bought for her personal use in 1981 at a cost of $12,000. Also on July 1, 1984, Kim sold 100 shares of Ra1 Corp. stock. Kim had received this stock on March 1, 1984, as a bequest from the estate of John Wolf who died on January 2, 1984, when this stock had a fair market value of $8,000. The executor of John’s estate did not elect the alternate valuation. John had bought this stock in 1970 for $1,000.

39. Kim’s basis for the 100 shares of Ra1 stock was:
   a. $0
   b. $1,000
   c. $8,000
   d. $10,000

2M84#27. On March 1, 1984, Harry Beech received a gift of income-producing real estate having a donor’s adjusted basis of $50,000 at the date of the gift. Fair market value of the property at the date of the gift was $40,000. Beech sold the property for $46,000 on August 1, 1984. How much gain or loss should Beech report for 1984?
   a. No gain or loss.
   b. $6,000 short-term capital gain.
   c. $4,000 short-term capital loss.
   d. $4,000 ordinary loss.

2M84

Items 34 through 36 are based on the following data:

On March 1, 1983, Lois Rice learned that she was bequeathed 1,000 shares of Elin Corp. common stock under the will of her uncle, Pat Prevor. Pat had paid $5,000 for the Elin stock in 1980. Fair market value of the Elin stock on March 1, 1983, the date of Pat’s death, was $8,000 and had increased to $11,000 six months later. The executor of Pat’s estate elected the alternative valuation date for estate tax purposes. Lois sold the Elin stock for $9,000 on May 1, 1983, the date that the executor distributed the stock to her.

34. How much should Lois include in her 1983 individual income tax return for the inheritance of the 1,000 shares of Elin stock which she received from Pat’s estate?
   a. $0
   b. $5,000
   c. $8,000
   d. $11,000

2M84

Items 22 through 28 are based on the following data:

Laura Lewis has been legally separated from her husband, Herman, since 1982. Their three-year-old son, Ronald, lived with Laura for the entire year 1983. Under the written separation agreement between Laura and Herman, Herman was obligated to pay Laura $300 per month for alimony and $200 per month for child support, or a total of $6,000 annually. However, Laura received a total of only $300 from Herman during 1983. Laura’s other income in 1983 was from the following sources:

```
Salary: $20,000
Interest on insurance dividends
   left on deposit with a life insurance company: 100
Interest on federal income tax refund: 60
```

In addition, Laura’s father, Albert, gave Laura a gift of 500 shares of Liba Corporation common stock in 1983. Albert’s basis for the Liba stock was $4,000. At the date of this gift, the fair market value of the Liba stock was $3,000.

25. How much was includible in Laura’s 1983 taxable income for the 500 shares of Liba stock?
   a. $0
   b. $3,000
   c. $3,500
   d. $4,000

26. If Laura sells the 500 shares of Liba stock in 1984 for $5,000, her basis is
   a. $5,000
   b. $4,000
   c. $3,000
   d. $0

27. If Laura sells the 500 shares of Liba stock in 1984 for $2,000, her basis is
   a. $4,000
   b. $3,000
   c. $2,000
   d. $0
2N83#25. Mr. & Mrs. John Hance jointly gave a $100,000 outright gift in 1982 to an unrelated friend, Fred Green, who needed the money to pay medical expenses. In filing their gift tax returns for 1982, Mr. & Mrs. Hance were entitled to exclusions aggregating a. $0  b. $6,000  c. $10,000  d. $20,000

2N83#26. In 1970, Edwin Ryan bought 100 shares of a listed stock for $5,000. In June 1982, when the stock's fair market value was $7,000, Edwin gave this stock to his sister, Lynn. No gift tax was paid. Lynn died in October 1982, bequeathing this stock to Edwin, when the stock's fair market value was $9,000. Lynn's executor did not elect the alternate valuation. What is Edwin's basis for this stock after he inherits it from Lynn's estate?
   a. $0  b. $5,000  c. $7,000  d. $9,000

1N82

Items 54 through 56 are based on the following data:

In 1978, John Cote bought 100 shares of a listed stock for $2,400. In 1980, when the fair market value was $2,200, John gave the stock to his brother, David. No gift tax was due.

54. If David sells this stock in 1982 for $2,600, his basis is
   a. $0  b. $2,200

55. If David sells this stock in 1982 for $2,000, his basis is
   a. $0  b. $2,000  c. $2,200  d. $2,400

56. If David sells this stock in 1982 for $2,300, his reportable gain or loss is
   a. $0.  b. $100 loss.  c. $100 gain.  d. $2,300 gain.

1N82#59. On January 10, 1970, Martin Mayne bought 3,000 shares of Hance Corporation stock for $300,000. The fair market values of this stock on the following dates were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31, 1980</td>
<td>$210,000</td>
</tr>
<tr>
<td>Mar. 31, 1981</td>
<td>240,000</td>
</tr>
<tr>
<td>June 30, 1981</td>
<td>270,000</td>
</tr>
</tbody>
</table>

Martin died on December 31, 1980, bequeathing this stock to his son, Philip. The stock was distributed to Philip on March 31, 1981. The alternate valuation date was elected for Martin's estate. Philip's basis for this stock is
   a. $210,000  b. $240,000  c. $270,000  d. $300,000
X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

A. Determination of Taxable Income or Loss

2M85#45. The filing of consolidated returns is available only to
a. Brother-sister corporations.
b. Parent-subsidiary affiliated groups.
c. Corporations that formally request advance permission from the IRS.
d. Corporations that issue their financial statements on a consolidated basis.

2M85 Items 46 through 52 are based on the following data:

Aki Corp., which was organized on January 2, 1981, had a book income of $500,000 for the year ended December 31, 1984. The following information was recorded in Aki's books and records during 1984:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of treasury stock to unrelated broker:</td>
<td></td>
</tr>
<tr>
<td>Proceeds received</td>
<td>$100,000</td>
</tr>
<tr>
<td>Cost</td>
<td>70,000</td>
</tr>
<tr>
<td>Par value</td>
<td>5,000</td>
</tr>
<tr>
<td>Dividends received from unaffiliated taxable domestic corporations</td>
<td>3,000</td>
</tr>
<tr>
<td>Long-term capital gains on sale of stock of unrelated corporations</td>
<td>12,000</td>
</tr>
<tr>
<td>Short-term capital losses on sale of stock of unrelated corporations</td>
<td>30,000</td>
</tr>
<tr>
<td>Sale of land (used in business) to Max Carr, who owns 55% of Aki's outstanding stock, but is neither an officer nor a director of Aki:</td>
<td></td>
</tr>
<tr>
<td>Sales price to Carr</td>
<td>40,000</td>
</tr>
<tr>
<td>Adjusted basis to Aki</td>
<td>44,000</td>
</tr>
<tr>
<td>Insurance premiums paid on policy insuring the life of Luke Ross, Aki's president (Aki is beneficiary of policy)</td>
<td>9,000</td>
</tr>
<tr>
<td>Cash dividends paid on outstanding 10% cumulative preferred stock</td>
<td>20,000</td>
</tr>
<tr>
<td>Interest paid to Ira Farb, who owns 1% of Aki's outstanding stock and is one of Aki's directors (Aki has a note payable to Farb for $60,000 borrowed from Farb in 1983 at 10% interest)</td>
<td>6,000</td>
</tr>
<tr>
<td>Amortization of organizational expenditures being written off over a 10-year period for financial statement purposes</td>
<td>1,000</td>
</tr>
</tbody>
</table>

46. How much capital gain should Aki report in its 1984 return on the sale of treasury stock?
   a. $0
   b. $5,000
   c. $30,000
   d. $95,000

47. Assuming that Aki has no portfolio indebtedness, how much is Aki's dividends-received deduction for 1984?
   a. $0
   b. $450
   c. $2,100
   d. $2,550

48. How much net capital loss can Aki deduct in its 1984 return on the sales of stock of unrelated corporations?
   a. $0
   b. $7,200
   c. $18,000
   d. $24,000

49. What is the allowable loss that Aki can claim in its 1984 return for the sale of land to Max Carr?
   a. $4,000 Section 1231 loss.
   b. $4,000 Section 1245 loss.
   c. $4,000 Section 1250 loss.
   d. $0.

50. How much can Aki deduct in its 1984 return for the insurance premiums paid on the policy insuring the life of Luke Ross?
   a. $0
   b. $4,000
   c. $5,000
   d. $9,000

51. How much can Aki deduct in its 1984 return for the dividends paid to preferred stockholders and for the interest paid to Ira Farb?
   a. $0
   b. $6,000
   c. $20,000
   d. $26,000

52. Aki is writing off its organizational expenditures over the minimum allowable period for tax purposes. How much can Aki deduct in its 1984 return for amortization of organizational expenditures?
   a. $1,000
   b. $1,500
   c. $2,000
   d. $3,000
Accounting Practice

2M84

Items 46 through 52 are based on the following data:

Max Finch was the sole stockholder of Burr, Inc., a company engaged principally in manufacturing operations. Burr’s retained earnings at December 31, 1982, amounted to $1,000,000. For the year ended December 31, 1983, Burr’s book income, before income taxes, was $300,000. Included in the computation of this $300,000 were the following:

- Gain on sale of land used in business: $10,000
- Loss on sale of long-term investments in marketable securities: $15,000
- Dividend income from unaffiliated domestic taxable corporations: $2,000
- Keyman insurance premiums paid on Finch’s life: $3,000
- Group life insurance premiums paid on employees’ lives (employees’ dependents are beneficiaries): $9,000
- Advertising Burr’s products in the convention program of a political party: $5,000
- Ticket for Burr’s sales manager to attend the state governor’s inaugural ball: $300
- Amortization of organization costs: $1,000

Total organization costs of $12,000 were incurred in January 1980, and are being amortized over a 12-year period for financial statement purposes. On July 1, 1983, Burr sold to Finch a plot of land that Burr was not using in its business. The sales price was $90,000, which was also Burr’s cost two years earlier. Fair market value of this land was $120,000 on July 1, 1983. In May 1984, Burr sold 100 shares of its $10 par value common stock to Al Hodge for $5,000, the fair market value at that date.

46. In computing taxable income for 1983, Burr should deduct a capital loss of

a. $0
b. $2,500
c. $5,000
d. $7,500

47. How much dividend income should Burr include in its 1983 taxable income?

a. $0
b. $300
c. $1,700
d. $2,000

48. In computing taxable income for 1983, how much can Burr deduct for keyman and group life insurance premiums?

a. $0
b. $3,000
c. $9,000
d. $12,000

49. In computing taxable income for 1983, what is the maximum deduction that Burr can claim for organization costs, assuming that the appropriate election was made on a timely basis?

a. $0
b. $600
c. $1,000
d. $2,400

51. In computing taxable income for 1983, how much can Burr deduct for the ticket to the governor’s inaugural ball and for the advertising in the political party’s convention program?

a. $0
b. $300
c. $5,000
d. $5,300

52. In 1984, Burr should treat the sale of its stock to Hodge as

a. Ordinary income of $5,000.
b. Short-term capital gain of $4,000.
c. Long-term capital gain of $4,000.
d. A nontaxable transaction.

2M84#1. Dale Corporation’s book income before federal income taxes was $520,000 for the year ended December 31, 1983. Dale was organized three years earlier. Organization costs of $260,000 are being written off over a ten-year period for financial statement purposes. For tax purposes these costs are being written off over the minimum allowable period. For the year ended December 31, 1983, Dale’s taxable income was

a. $468,000
b. $494,000
c. $520,000
d. $546,000

2M84#2. Roper Corp. had operating income of $200,000, after deducting $12,000 for contributions, but not including dividends of $20,000 received from nonaffiliated domestic taxable corporations. How much is the base amount to which the percentage limitation should be applied in computing the maximum allowable deduction for contributions?

a. $212,000
b. $215,000
c. $220,000
d. $232,000

2M84#3. Rose Budd owns 55% of the outstanding stock of Kee Corp. During 1983, Kee sold a machine to Rose for $80,000. This machine had an adjusted tax basis of $92,000, and had been owned by Kee for three years. What is the allowable loss that Kee can claim in its 1983 income tax return?

a. $12,000 Section 1245 loss.
b. $12,000 Section 1231 loss.
c. $12,000 ordinary loss.
d. $0.

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2MB4#5. Arch Corp. sold machinery for $80,000 on December 31, 1983. This machinery was purchased on January 2, 1979, for $68,000, and had an adjusted basis of $40,000 at the date of sale. For 1983 Arch should report
   a. Ordinary income of $12,000 and Section 1231 gain of $28,000.
   b. Ordinary income of $28,000 and Section 1231 gain of $12,000.
   c. Ordinary income of $40,000.
   d. Section 1231 gain of $40,000.

2MB4
Items 8 through 10 are based on the following data:

Pym, Inc., which had earnings and profits of $100,000, distributed land to Alex Rowe, a stockholder, as a dividend in kind. Pym’s adjusted basis for this land was $3,000. The land had a fair market value of $12,000 and was subject to a mortgage liability of $5,000, which was assumed by Rowe.

8. How much was Pym’s gain on the distribution?
   a. $9,000
   b. $4,000
   c. $2,000
   d. $0

2MB4#13. Ace Corp. files a consolidated return with its wholly-owned subsidiary, Barr Corp. During 1983, Barr paid a cash dividend of $10,000 to Ace. How much of this dividend is taxable on the 1983 consolidated return?
   a. $0
   b. $1,500
   c. $8,500
   d. $10,000

2N83#44. Yuki Corp., which began business in 1982, incurred the following costs in 1982 in connection with organizing the corporation:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Printing of stock certificates</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Underwriters' commissions on sale of stock</td>
<td>100,000</td>
</tr>
</tbody>
</table>

What portion of these costs qualifies as amortizable organization expenses deductible ratably over a period of not less than 60 months?
   a. $105,000
   b. $100,000
   c. $5,000
   d. $0

2N83#45. For the year ended December 31, 1982, Seco Corp. had an operating income of $9,500. In addition, Seco had the following capital gains and losses:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net short-term capital gain</td>
<td>$1,000</td>
</tr>
<tr>
<td>Net long-term capital loss</td>
<td>9,000</td>
</tr>
</tbody>
</table>

How much of the excess of net long-term capital loss over net short-term capital gain could Seco offset against ordinary income in 1982?
   a. $0
   b. $3,000
   c. $3,500
   d. $8,000

2N83#47. For the year ended December 31, 1982, Haya Corp. had gross business income of $600,000 and expenses of $800,000. Contributions of $5,000 to qualified charities were included in expenses. In addition to the expenses, Haya had a net operating loss carryover of $9,000. What was Haya’s net operating loss for 1982?
   a. $209,000
   b. $204,000
   c. $200,000
   d. $195,000

2N83
Items 48 and 49 are based on the following data:

Nilo Corp., a restaurant, commenced operations on January 1, 1982. For the year ended December 31, 1982, Nilo incurred a net operating loss of $100,000. In addition, Nilo had a net capital loss of $7,000 in 1982 from the sale of stock of an unrelated company.

48. What is the maximum carryover period for Nilo’s 1982 net operating loss?
   a. 15 years.
   b. 7 years.
   c. 5 years.
   d. 3 years.

49. What is the maximum carryover period for Nilo’s 1982 net capital loss?
   a. 3 years.
   b. 5 years.
   c. 8 years.
   d. Indefinite, until used.

2N83#50. When Kile Corp. was organized in 1975, it received $100,000 from the sale of 10,000 shares of its $10 par value common stock. In 1980, Kile reacquired
of these shares as treasury stock, at a cost of $6,000. In 1983, Kile sold the 300 shares of treasury stock to an unrelated party for $7,500. How much capital gain should Kile report in its 1983 tax return in connection with the sale of these 300 shares?

- a. $4,500
- b. $3,000
- c. $1,500
- d. $0

2M83#59. During the 1982 holiday season, Palo Corp. gave business gifts to 17 customers. These gifts, which were not of an advertising nature, had the following fair market values:

- 4 @ $ 10
- 4 @ $ 25
- 4 @ $ 50
- 5 @ $100

How much of these gifts was deductible as a business expense for 1982?

a. $840
b. $365
c. $140
d. $0

2M83#43. During 1983 Wyld Corp., in need of additional factory space, exchanged 10,000 shares of its common stock with a par value of $50,000 for a building with a fair market value of $60,000. On the date of the exchange the stock had a fair market value of $65,000. For 1983, how much and what type of gain or loss should Wyld report on this transaction?

- a. $10,000 section 1231 gain.
- b. $10,000 capital gain.
- c. $5,000 capital loss.
- d. No gain or loss.

2M83#44. Lonky Corporation’s condensed income statement for the year ended December 31, 1982, was as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income</td>
<td>$500,000</td>
</tr>
<tr>
<td>Business costs and expenses</td>
<td>-475,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>-5,000</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>$ 20,000</td>
</tr>
</tbody>
</table>

The maximum amount deductible by Lonky for charitable contributions in its 1982 income tax return is

- a. $1,000
- b. $1,250
- c. $2,000
- d. $2,500

2M83#49. Barbaro Corporation’s retained earnings at January 1, 1982, was $600,000. During 1982 Barbaro paid cash dividends of $150,000 and received a federal income tax refund of $26,000 as a result of an IRS audit of Barbaro’s 1979 tax return. Barbaro’s net income per books for the year ended December 31, 1982, was $274,900 after deducting federal income tax of $183,300. How much should be shown in the reconciliation schedule M-2, of Form 1120, as Barbaro’s retained earnings at December 31, 1982?

- a. $443,600
- b. $600,900
- c. $626,900
- d. $750,900

2M83#50. The following assets were among those owned by Yolanda Corporation at December 31, 1982:

- Delivery truck $12,000
- Land used as parking lot for customers 20,000

The capital assets amount to

- a. $0
- b. $12,000
- c. $20,000
- d. $32,000

2M83#52. Claudio Corporation and Stellar Corporation both report on a calendar-year basis. Claudio merged into Stellar on June 30, 1982. Claudio had an allowable net operating loss carryover of $270,000. Stellar’s taxable income for the year ended December 31, 1982, was $360,000 before consideration of Claudio’s net operating loss carryover. How much of Claudio’s net operating loss carryover can be used to offset Stellar’s 1982 taxable income?

- a. $0
- b. $135,000
- c. $180,000
- d. $270,000

2M82#41. Richards Corporation had taxable income of $280,000 before deducting charitable contributions for its tax year ended December 31, 1982. The dividends received deduction was $34,000. Richards made cash contributions of $35,000 to charitable organizations. How much can Richards deduct as contributions for 1982?

- a. $28,000
- b. $31,400
- c. $32,000
- d. $35,000

2M82#42. Anderson Corporation realized taxable income of $72,000 from its regular business operations for calendar year 1981. In addition Anderson had the following capital gains and losses during 1981:

- Short-term capital gain $17,000
- Short-term capital loss (8,000)
- Long-term capital gain 3,000
- Long-term capital loss (7,000)
Anderson did not realize any other capital gains or losses since it began operations. What is Anderson’s total taxable income for 1981?

a. $77,000
b. $81,000
c. $84,000
d. $92,000

2N82#43. In 1981 Studley Corporation, not a dealer in securities, realized taxable income of $80,000 from the operation of its business. Additionally in 1981, Studley realized a long-term capital loss of $12,000 from the sale of marketable securities. Studley did not realize any other capital gains or losses since it began operations. What is the proper treatment for the $12,000 long-term capital loss in Studley’s income tax returns?

a. Use $3,000 of the loss to reduce taxable income for 1981, and carry $9,000 of the long-term capital loss forward five years.
b. Use $6,000 of the loss to reduce taxable income by $3,000 for 1981, and carry $6,000 of the long-term capital loss forward five years.
c. Use $12,000 of the long-term capital loss to reduce taxable income by $6,000 for 1981.
d. Carry the $12,000 long-term capital loss forward five years, treating it as a short-term capital loss.

2N82#46. During 1981 Culbert, Inc., made the following expenditures:

Promotional materials for use on customers’ premises (1,000 @ $40) $40,000
Business gifts to customers (60 @ $100) 6,000
Contribution to a candidate for public office 1,000

How much of the above expenditures should Culbert deduct in determining its taxable income for 1981?

a. $26,500
b. $41,500
c. $42,500
d. $47,000

2N82#50. For the year ended December 31, 1981, Atkinson, Inc., had gross business income of $160,000 and dividend income of $100,000 from unaffiliated domestic corporations. Business deductions for 1981 amounted to $170,000. What is Atkinson’s dividends received deduction for 1981?

a. $0
b. $76,500
c. $85,000
d. $90,000

2N82#51. Martin Corporation purchased a machine for $550,000 on January 1, 1979. Martin sold the machine for $450,000 on December 31, 1981, at which date the accumulated depreciation amounted to $270,000. How much should Martin report as a section 1231 gain for the year ended December 31, 1981?

a. $0
b. $85,000
c. $100,000
d. $170,000

2N82#53. Bishop Corporation reported taxable income of $700,000 on its federal income tax return for calendar year 1981. Selected information for 1981 is available from Bishop’s records as follows:

Provision for federal income tax per books $280,000
Depreciation claimed on the tax return 130,000
Depreciation recorded in the books 75,000
Life insurance proceeds on death of corporate officer 100,000

Bishop reported net income per books for 1981 of:

a. $855,000  b. $595,000  c. $575,000  d. $475,000

2M82#42. Sportsworld, Inc., issued $500,000 face amount of bonds in 1976, and established a sinking fund to pay the debt. An independent trustee was appointed by the bondholders to administer the sinking fund. In 1981, the sinking fund earned $30,000 in interest on bank deposits, and $2,000 in net short-term capital gains. How much of this income is taxable to Sportsworld?

a. $0  b. $2,000  c. $30,000  d. $32,000

2M82#49. Monaro Corporation had the following income and expenses for the year ended December 31, 1981:

Gross profit on sales $300,000
Administrative expenses 700,000
Dividends from nonaffiliated domestic taxable corporations 20,000

How much is Monaro’s net operating loss for 1981?

a. $380,000  b. $383,000  c. $397,000  d. $400,000

2M82#50. Olex Corporation’s books disclosed the following data for the calendar year 1981:

Retained earnings at beginning of year $50,000
Net income for year 70,000
Contingency reserve established at end of year 10,000
Cash dividends paid during year 8,000

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What amount should appear on the last line of reconciliation Schedule M-2 of Form 1120?

a. $102,000  
b. $120,000  
c. $128,000  
d. $138,000

1N81#42. Paramount Corporation has consistently used the reserve method to compute the bad debt deduction on its tax returns. The year-end reserve for bad debts reported on the 1979 tax return was $11,200. Additional information is available as follows:

<table>
<thead>
<tr>
<th>Accounts receivable at end of year</th>
<th>Bad debt</th>
<th>Losses</th>
<th>Recoveries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>$255,000</td>
<td>$12,000</td>
<td>$1,150</td>
</tr>
<tr>
<td>1976</td>
<td>$265,000</td>
<td>13,500</td>
<td>1,300</td>
</tr>
<tr>
<td>1977</td>
<td>$270,000</td>
<td>11,500</td>
<td>1,450</td>
</tr>
<tr>
<td>1978</td>
<td>$250,000</td>
<td>12,000</td>
<td>1,500</td>
</tr>
<tr>
<td>1979</td>
<td>$280,000</td>
<td>14,000</td>
<td>1,920</td>
</tr>
<tr>
<td>1980</td>
<td>$300,000</td>
<td>18,000</td>
<td>2,400</td>
</tr>
<tr>
<td>Totals</td>
<td>$1,620,000</td>
<td>$81,000</td>
<td>$9,720</td>
</tr>
<tr>
<td>% of receivables</td>
<td>5.0%</td>
<td>0.6%</td>
<td></td>
</tr>
</tbody>
</table>

In December 1980 one of Paramount's important customers experienced financial difficulties, which could result in a bad debt write-off of $10,000 during 1981 in respect of this customer. What is the maximum bad debt deduction that Paramount can claim on its tax return for 1980?

a. $13,200  
b. $17,600  
c. $19,400  
d. $27,600

1N81#43. In 1980 Trapp, Inc., had $400,000 of gross profit from operations and $160,000 of dividends from nonaffiliated domestic corporations. Trapp's operating expenses totaled $410,000. What is Trapp's dividends received deduction for 1980?

a. $80,000  
b. $127,500  
c. $136,000  
d. $160,000

1N81#45. Bellamy Corporation reported Retained Earnings-Unappropriated of $1,500,000 at December 31, 1979, on its 1979 tax return. Information for 1980 is available as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income per books</td>
<td>$600,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>850,000</td>
</tr>
<tr>
<td>Dividends paid on common stock</td>
<td>450,000</td>
</tr>
<tr>
<td>Debit adjustment to the beginning balance of retained earnings for correction of an accounting error</td>
<td>500,000</td>
</tr>
</tbody>
</table>

What amount should Bellamy report for Retained Earnings-Unappropriated at December 31, 1980, on its 1980 tax return?

a. $1,150,000  
b. $1,400,000  
c. $1,650,000  
d. $1,900,000

1N81#47. Carr, Inc., a calendar-year corporation incorporated in January 1975, had a net operating loss of $75,000 in 1979. For each of the years 1975-1978, Carr reported taxable income (loss) before net operating loss deduction as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>$15,000</td>
</tr>
<tr>
<td>1976</td>
<td>(20,000)</td>
</tr>
<tr>
<td>1977</td>
<td>10,000</td>
</tr>
<tr>
<td>1978</td>
<td>30,000</td>
</tr>
</tbody>
</table>

When filing its tax return for 1979, Carr did not elect to give up the carryback of its loss for 1979. Carr's taxable income before net operating loss deduction for 1980 was $80,000. Carr should report a net operating loss deduction on its tax return for 1980 of

a. $30,000  
b. $35,000  
c. $40,000  
d. $55,000

1N81#50. Regan Corporation purchased a machine for $180,000 on January 1, 1977, and established an annual depreciation rate of 10% using the straight-line method, with no salvage value. On December 31, 1980, Regan determined that the actual obsolescence was substantially higher than was anticipated at the time of purchase, and that the machine will not be economically useful after December 31, 1982. Assuming that Regan can justify the change, how much depreciation for this machine should Regan deduct on its tax return for the year ended December 31, 1980?

a. $18,000  
b. $30,000  
c. $42,000  
d. $66,000

1N81#51. In 1980, its first year of operations, Rowley Corporation, not a dealer in securities, realized taxable income of $128,000 from the operation of its business. In addition to its regular business operations, it realized the following gains and losses from the sale of marketable securities:

- Short-term capital gain: $10,000
- Short-term capital loss: (4,000)
- Long-term capital gain: 12,000
- Long-term capital loss: (32,000)

What is Rowley's total taxable income for 1980?

a. $114,000  
b. $124,000  
c. $128,000  
d. $134,000
1M81#52. For the year ended December 31, 1980, Powell, Inc., reported $900,000 income before federal taxes per books which included the following items:

- State corporate income tax refunds: $8,000
- Interest income on tax-exempt municipal securities: $30,000
- Loss on sale of land acquired in 1975 for investment: $40,000
- Interest expense on loan to purchase tax-exempt municipal securities: $16,000

What is the taxable income of Powell for 1980?

a. $886,000
b. $900,000
c. $918,000
d. $926,000

2M81#41. On October 1, 1980, Derek Corporation sold 4,000 shares of its $10 par value treasury stock for $60,000. These shares were acquired by Derek on January 2, 1980, for $50,000. For 1980 Derek should report:

a. Neither income nor capital gain.
b. A long-term capital gain of $10,000.
c. A short-term capital gain of $10,000.
d. A long-term capital gain of $20,000.

2M81#42. For the year ended December 31, 1980, Apollo Corporation had net income per books of $1,200,000. Included in the determination of net income were the following items:

- Interest income on municipal bonds: $40,000
- Gain on settlement of life insurance policy (death of officer): $200,000
- Interest paid on loan to purchase municipal bonds: $8,000
- Provision for federal income tax: $524,000

What should Apollo report as its taxable income for 1980?

a. $1,492,000
b. $1,524,000
c. $1,684,000
d. $1,692,000

2M81#44. On December 31, 1960, Homer Corporation issued $2,000,000 of fifty-year bonds for $2,600,000. On December 31, 1980, Homer issued new bonds with a face value of $3,000,000 for which it received $3,400,000 and used part of the proceeds to repurchase for $2,320,000 the bonds issued in 1960. No elections were made to adjust the basis of any property. What is the taxable income to Homer on the repurchase of the 1960 bonds?

a. $0
b. $40,000
c. $280,000
d. $360,000

2M81#53. During 1980 Waner Corporation exchanged 10,000 shares of its own common stock with a par value of $10 per share for a building with a fair market value of $150,000. What should Waner report in its 1980 tax return as a result of this transaction?

a. No gain.
b. $50,000 ordinary income.
c. $50,000 Section 1231 gain.
d. $50,000 Section 1245 gain.

2M81#56. Delve Co., Inc., issued $1,000,000 of 8-year convertible bonds on October 1, 1980, for $880,000. The amount of bond discount deductible on Delve's income tax return for the year ended March 31, 1981, is:

a. $0
b. $7,500
c. $15,000
d. $120,000

2M81#58. Elmo Corporation had the following income and expenses for the year ended December 31, 1980:

- Gross profit on sales: $150,000
- Dividends from domestic taxable corporations: $15,000
- Salaries and wages: $90,000
- Interest expense: $22,500
- Taxes on real estate and payroll: $52,500
- Depreciation: $15,000
- Contributions: $7,500

Elmo's net operating loss for 1980 is:

a. $15,000
b. $17,250
c. $22,500
d. $27,750

B. Tax Computations and Credits

2N84#59. In computing its 1983 minimum tax, a corporation must include as a tax preference:

a. The dividends-received deduction.
b. ACRS excess deduction on 15-year real property.
c. Charitable contributions.
d. Interest expense on investment property.

2N84#60. A corporation may reduce its income tax by taking a tax credit for:

a. Foreign taxes.
b. Political contributions.
c. State taxes.
d. Excess charitable contributions.
2M84#11. In computing a corporation’s taxable income, a net capital loss is
   a. Deductible in full in the year sustained.
   b. Deductible to a maximum extent of 50% in the year sustained.
   c. Not deductible at all in the year sustained.
   d. Limited to a maximum deduction of $3,000 in the year sustained.

2M83#55. Orna Corp., a calendar-year taxpayer, had an unused investment credit of $8,000 at December 31, 1982, its first taxable year. For how many years can Orna carry over this unused investment credit?
   a. 15
   b. 7
   c. 5
   d. 3

2N82#48. Dorsett Corporation’s income tax return for 1981 shows deductions exceeding gross income by $56,800. Included in the tax return are the following items:
   Net operating loss deduction (carryover from 1980) $15,000
   Dividends received deduction 6,800

What is Dorsett’s net operating loss for 1981?
   a. $56,800
   b. $50,000
   c. $41,800
   d. $35,000

2N82#57. Foster Corporation’s tax liability for the year ended December 31, 1981, was $15,000 before claiming an investment tax credit. On July 1, 1981, Foster purchased a new truck for $180,000. The truck is appropriately categorized by Foster as five-year property under the accelerated cost recovery system. Foster’s allowed investment tax credit for 1981 is
   a. $ 9,000
   b. $12,000
   c. $15,000
   d. $18,000

2M82#60. On July 1, 1981, Pemberton Corporation bought a new drill press for $20,000, which was placed in service the same day. The drill press qualifies as five-year accelerated cost recovery system property, for which an investment credit of $2,000 was claimed. If Pemberton disposes of this drill press on May 31, 1983, how much of the investment credit must be recaptured in 1983?
   a. $0
   b. $1,200
   c. $1,600
   d. $2,000

1N81#55. During 1980 Bell Corporation had worldwide taxable income of $675,000 and a tentative United States income tax of $270,000. Bell’s taxable income from business operations in Country A was $300,000, and foreign income taxes imposed were $135,000 stated in United States dollars.

How much should Bell claim as a credit for foreign income taxes on its United States income tax return for 1980?
   a. $0
   b. $75,000
   c. $120,000
   d. $135,000

2M81#59. Baxter Manufacturers, Inc., a calendar-year corporation, bought the following new assets during 1980:

<table>
<thead>
<tr>
<th>Property</th>
<th>Date placed in service</th>
<th>Useful life (years)</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manuals</td>
<td>Jan. 4</td>
<td>2</td>
<td>$210</td>
</tr>
<tr>
<td>Truck</td>
<td>June 30</td>
<td>3</td>
<td>15,000</td>
</tr>
<tr>
<td>Desk and chair</td>
<td>Dec. 1 Dec. 31</td>
<td>7</td>
<td>1,200</td>
</tr>
</tbody>
</table>

Baxter’s total qualified investment in 1980 for computation of the investment credit is
   a. $2,570
   b. $3,920
   c. $6,200
   d. $6,270

C. S Corporations

2M85#55. For the year ended December 31, 1984, Elk Inc., an S corporation, had net income per books of $54,000, which included $45,000 from operations and a $9,000 net long-term capital gain. During 1984, $22,500 was distributed to Elk’s three equal stockholders, all of whom are on a calendar-year basis. On what amounts should Elk compute its income and capital gain taxes?

<table>
<thead>
<tr>
<th>Ordinary income</th>
<th>Long-term capital gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $31,500</td>
<td>$0</td>
</tr>
<tr>
<td>b. $22,500</td>
<td>$0</td>
</tr>
<tr>
<td>c. $0</td>
<td>$9,000</td>
</tr>
<tr>
<td>d. $0</td>
<td>$0</td>
</tr>
</tbody>
</table>

2N84#41. An S corporation may
   a. Have both common and preferred stock.
   b. Have a corporation as a shareholder.
   c. Be a member of an affiliated group.
   d. Have as many as 35 shareholders.

2M84#16. Lindal Corp., organized in 1984, immediately filed an election for S corporation status under the rules of Subchapter S. What is the maximum amount of passive investment income that Lindal will
be allowed to earn and still qualify as an S corporation (Subchapter S)?
   a. 80% of gross receipts.
   b. 50% of gross receipts.
   c. 20% of gross receipts.
   d. No limit on passive investment income.

2M83#41. Luba Corp. was organized in 1983 with the intention of operating as an S corporation (Subchapter S). What is the maximum number of stockholders allowable for eligibility as an S corporation (Subchapter S)?
   a. 35
   b. 15
   c. 9
   d. 5

2M83#46. Which of the following is not a requirement for a corporation to elect S corporation status (Subchapter S)?
   a. Must be a member of a controlled group.
   b. Must confine stockholders to individuals, estates, and certain qualifying trusts.
   c. Must be a domestic corporation.
   d. Must have only one class of stock.

2M82#52. Keller, Inc., a Subchapter S corporation, has three equal shareholders. For the year ended December 31, 1981, Keller had taxable income and current earnings and profits of $150,000. Keller made cash distributions totaling $60,000 during 1981. For the calendar year 1981, what amount should be included in each shareholder’s gross income from Keller?
   a. $20,000
   b. $30,000
   c. $50,000
   d. $70,000

2M82#56. Grant Corporation, a Subchapter S corporation, had taxable income and current earnings and profits of $36,000 for the year ended December 31, 1981. Included in the above is $24,000 excess net long-term capital gain over net short-term capital loss. Cash distributions to Mr. Hamlin, the sole shareholder, totaled $72,000 during 1981. On December 31, 1980, Grant had accumulated earnings and profits of $60,000, none of which had been previously taxed. What amount should Hamlin report on his 1981 individual income tax return as long-term gain passed through from Grant?
   a. $0
   b. $8,000
   c. $12,000
   d. $24,000

2M82#52. Brooke, Inc., a Subchapter S corporation, was organized on January 2, 1981, with two equal stockholders. Each stockholder invested $5,000 in Brooke’s capital stock, and each loaned $15,000 to the corporation. Brooke then borrowed $60,000 from a bank for working capital. Brooke sustained an operating loss of $90,000 for the year ended December 31, 1981. How much of this loss can each stockholder claim on his 1981 income tax return?
   a. $5,000
   b. $20,000
   c. $45,000
   d. $50,000

2M81#46. For its year ended December 31, 1980, Valor Corporation, a Subchapter S Corporation, had net income per books of $216,000 which included $180,000 from operations and a $36,000 net long-term capital gain. During 1980, $90,000 was distributed to the corporation’s nine equal shareholders, all of whom are on a calendar-year basis. Each shareholder should report for 1980
   a. $10,000 ordinary income.
   b. $20,000 ordinary income.
   c. $20,000 ordinary income and $4,000 long-term capital gain.
   d. $24,000 ordinary income.

2M81#47. Marina Corporation, a Subchapter S Corporation, had taxable income and current earnings and profits of $390,000 for the year ended December 31, 1980. There were no capital gains or losses during 1980. For the year ended December 31, 1979, Marina had undistributed taxable income of $90,000. During 1980 Marina made the following cash distributions to its ten equal shareholders:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>$50,000</td>
</tr>
<tr>
<td>March</td>
<td>80,000</td>
</tr>
<tr>
<td>October</td>
<td>60,000</td>
</tr>
</tbody>
</table>

What is the undistributed taxable income for the year ended December 31, 1980?
   a. $200,000
   b. $290,000
   c. $300,000
   d. $330,000

2M81#54. Robert Elk paid $100,000 for all of the issued and outstanding capital stock of Elkom Corp., a Subchapter S corporation established in January 1978. Elkom’s operating results and dividend distribution were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Taxable income</th>
<th>Net operating loss</th>
<th>Dividend distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/78</td>
<td>($40,000)</td>
<td></td>
<td>$20,000</td>
</tr>
<tr>
<td>9/30/79</td>
<td></td>
<td></td>
<td>$20,000</td>
</tr>
<tr>
<td>12/31/79</td>
<td>$60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/80</td>
<td>$30,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The basis of Elk’s stock on December 31, 1980, is
   a. $50,000
   b. $100,000
   c. $130,000
   d. $150,000
D. Personal Holding Companies

2M85#44. Where passive investment income is involved, the personal holding company tax may be imposed
   a. On both partnerships and corporations.
   b. On companies whose gross income arises solely from rentals, if the lessors render no
      services to the lessees.
   c. If more than 50% of the company is owned by five or fewer individuals.
   d. On small business investment companies licensed by the Small Business Administration.

2N84#44. Alston Corp. has three stockholders and derives all of its income from investments in stock and
   securities. Alston regularly distributes 51% of its taxable income as dividends to its stockholders. Alston is
   a (an)
   a. Corporation subject to the
   b. Personal holding company.
   c. Exempt organization.
   d. Regulated investment company.

2M84#18. The personal holding company tax
   a. Is imposed on corporations having 50 or more
   b. Applies regardless of the extent of dividend
   c. Should be self-assessed by filing a separate
   d. May apply if at least 20% of the corporation’s

2N83
   Items 56 and 57 are based on the following statements which pertain either to the accumulated earnings tax, or
to the personal holding company tax, or to both:

   (1) Imposition of the tax depends on a stock ownership test specified in the statute.
   (2) Imposition of the tax can be mitigated by sufficient dividend distributions.
   (3) The tax should be self-assessed by filing a separate schedule along with the regular tax return.

57. Which of the foregoing statements pertain to the personal holding company tax?
   a. (1) only.
   b. (2) only.
   c. (3) only.
   d. (1), (2), and (3).

2M83#41. Hedge Holding Corporation has 100 unrelated stockholders, each of whom owns 100 shares of
   Hedge stock. For the year ended December 31, 1982, Hedge’s adjusted gross income consisted of the follow-
   ing:

   Dividends from domestic
taxable corporations $20,000
   Interest earned on
   U.S. Treasury notes 12,000
   Net rental income 6,000

   Deductible expenses for 1982 totaled $8,000. Hedge paid no dividends in 1982. Hedge’s liability for personal
   holding company tax for 1982 will be based on undistributed personal holding company income of
   a. $0
   b. $ 7,000
   c. $13,000
   d. $30,000

2M81#60. Cromwell Investors, Inc., has ten unrelated equal stockholders. For the year ended June 30, 1980,
   Cromwell’s adjusted gross income comprised the fol-
   lowing:

   Dividends from domestic taxable
corporations $10,000
   Dividends from savings and loan
   associations on passbook savings
   accounts 1,000
   Interest earned on notes receivable 5,000
   Net rental income 3,000

   The corporation paid no dividends during the taxable
   year. Deductible expenses totaled $4,000 for the year.
   Cromwell’s liability for personal holding company tax
   for the year will be based on undistributed personal
   holding company income of
   a. $0
   b. $ 3,500
   c. $ 6,500
   d. $15,000

E. Accumulated Earnings Tax

2M85#43. The accumulated earnings tax
   a. Depends on a stock ownership test based on
   b. Can be avoided by sufficient dividend distri-
   c. Is computed by the filing of a separate sched-
   d. Is imposed when the entity is classified as a

2N84#53. In determining accumulated taxable income
   for the purpose of the accumulated earnings tax, which
   one of the following is allowed as a deduction?
   a. Capital loss carryover from prior year.
   b. Dividends-received deduction.
   c. Net operating loss deduction.
   d. Net capital loss for current year.
2M84#12. The accumulated earnings tax does not apply to corporations that
   a. Have more than one class of stock.
   b. Are personal holding companies.
   c. Are members of a controlled group.
   d. Are manufacturing enterprises.

2N83 Items 56 and 57 are based on the following statements which pertain either to the accumulated earnings tax, or to the personal holding company tax, or to both:
   (1) Imposition of the tax depends on a stock ownership test specified in the statute.
   (2) Imposition of the tax can be mitigated by sufficient dividend distributions.
   (3) The tax should be self-assessed by filing a separate schedule along with the regular tax return.

56. Which of the foregoing statements pertain to the accumulated earnings tax?
   a. (1) only.
   b. (2) only.
   c. (3) only.
   d. (1), (2), and (3).

2M83#42. The minimum accumulated earnings credit beginning in 1982 is
   a. $150,000 for all corporations.
   b. $150,000 for nonservice corporations only.
   c. $250,000 for all corporations.
   d. $250,000 for nonservice corporations only.

F. Distributions

2M85#53. The following information pertains to Peel Corp.:

Accumulated earnings and profits at
   January 1, 1984  $15,000

Earnings and profits for the year ended
   December 31, 1984  18,000

Dividends distributed to individual share-
   holders during 1984  52,500

How much of the dividends are taxable as dividend income to Peel's shareholders in 1984 before any available exclusions?
   a. $15,000
   b. $18,000
   c. $33,000
   d. $52,500

2N84 Items 46 through 52 are based on the following data:

Max Finch was the sole stockholder of Burr, Inc., a company engaged principally in manufacturing op-

Selected Questions

Gain on sale of land used in business  $10,000
Loss on sale of long-term investments  15,000
in marketable securities
Dividend income from unaffiliated  2,000
  domestic taxable corporations
Keyman insurance premiums paid on
  Finch's life (Burr is beneficiary)  3,000
Group life insurance premiums paid on
  employees' lives (employees' dependents
  are beneficiaries)  9,000
Advertising Burr's products in the
  convention program of a political party  5,000
Ticket for Burr's sales manager to attend
  the state governor's inaugural ball  300
Amortization of organization costs  1,000

Total organization costs of $12,000 were incurred in January 1980, and are being amortized over a 12-year period for financial statement purposes. On July 1, 1983, Burr sold to Finch a plot of land that Burr was not using in its business. The sales price was $90,000, which was also Burr's cost two years earlier. Fair market value of this land was $120,000 on July 1, 1983. In May 1984, Burr sold 100 shares of its $10 par value common stock to Al Hodge for $5,000, the fair market value at that date.

50. Finch should personally treat his $90,000 purchase of the land as a
   a. $30,000 dividend.
   b. $30,000 long-term capital gain.
   c. $30,000 Section 1231 gain.
   d. Nontaxable transaction.

2M84 Items 8 through 10 are based on the following data:

Pym, Inc., which had earnings and profits of $100,000, distributed land to Alex Rowe, a stockholder, as a dividend in kind. Pym's adjusted basis for this land was $3,000. The land had a fair market value of $12,000 and was subject to a mortgage liability of $5,000, which was assumed by Rowe.

9. Before the dividend exclusion, how much of the distribution was taxable to Rowe as a dividend?
   a. $9,000
   b. $7,000
   c. $4,000
   d. $3,000

10. If the distribution of the dividend in kind had been made to Kile Corporation instead of to Alex Rowe (an
individual), how much of the distribution would be reportable by Kile as a dividend, before the dividends-received deduction?

a. $0  
b. $3,000  
c. $7,000  
d. $12,000

2M83#60. Lara Corporation’s stock is owned by Toty, Inc., a Delaware corporation. At December 31, 1982, the close of Lara’s taxable year, Lara had earnings and profits of $90,000. In December 1982, Lara made a distribution of land to Toty. Lara’s adjusted basis for this land was $25,000, while the land’s fair market value at the date of distribution was $40,000. Lara had no recognized gain or loss on this property distribution. How much of this property distribution should be treated as a dividend in 1982?

a. $0  
b. $15,000  
c. $25,000  
d. $40,000

2M82#49. On December 31, 1981, King Corporation distributed to Mary Spencer, its sole shareholder, as a dividend in kind, a tract of land that was not an inventory asset. Immediately prior to the distribution on December 31, 1981, the following data were available:

| Adjusted basis of the land | $30,000 |
| Fair market value of the land | 25,000 |
| Accumulated earnings and profits | 50,000 |

By how much should the dividend distribution reduce King’s accumulated earnings and profits?

a. $20,000  
b. $25,000  
c. $30,000  
d. $35,000

2M81#57. On June 30, 1980, Ral Corporation had retained earnings of $100,000. On that date, it sold a plot of land to a stockholder for $50,000. Ral had paid $40,000 for the land in 1975, and it had a fair market value of $80,000 when the stockholder bought it. The amount of dividend income taxable to the stockholder in 1980 (before the dividend exclusion) is

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

G. Tax-Free Incorporation

2M85#41. To qualify for tax-free incorporation, a sole proprietor must be in control of the transferee corporation immediately after the exchange of the proprietorship’s assets for the corporation’s stock. “Control” for this purpose means ownership of stock amounting to at least

a. 50.00%  
b. 51.00%  
c. 66.67%  
d. 80.00%

2M84#20. James Bell, CPA, a sole practitioner reporting on the cash basis, incorporated his accounting practice in 1984, transferring the following assets to the newly formed corporation:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000</td>
</tr>
<tr>
<td>Office furniture and equipment:</td>
<td></td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>35,000</td>
</tr>
<tr>
<td>Fair market value</td>
<td>45,000</td>
</tr>
</tbody>
</table>

No liabilities were transferred, and there were no other stockholders. The corporation’s total basis for the transferred assets is

a. $35,000  
b. $40,000  
c. $45,000  
d. $50,000

2M83#46. In 1982, Dr. Ernest Griffiths, a cash basis taxpayer, incorporated his medical practice. No liabilities were transferred. The following assets were transferred to the corporation:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
</tr>
<tr>
<td>Equipment:</td>
<td></td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>140,000</td>
</tr>
<tr>
<td>Fair market value</td>
<td>180,000</td>
</tr>
</tbody>
</table>

Immediately after the transfer, Griffiths owned 100% of the corporation’s stock. The corporation’s total basis for the transferred assets is

a. $140,000  
b. $160,000  
c. $180,000  
d. $200,000

2M82#54. On April 1, 1982, Crowe and Greene formed Apex Corporation. The same day Crowe paid $150,000 for 500 shares of Apex common stock, and Greene transferred land and building to Apex in exchange for 500 shares of common stock. The land and building had an adjusted basis to Greene of $120,000, a fair market value of $200,000, and was subject to a mortgage of $60,000 on April 1, 1982. The mortgage was assumed by Apex. Apex had no other shares of stock outstanding on April 1, 1982. The basis of the land and building to Apex on April 1, 1982, is

a. $60,000  
b. $120,000  
c. $140,000  
d. $150,000
2M82#45. On July 1, 1981, Alan Rees, sole proprietor of Kee Nail, transferred all of Kee’s assets to Merit, Inc., a new corporation, solely in exchange for a certain percentage of Merit’s stock. Al Clyde, who is not related to Rees, bought the rest of Merit’s stock on July 1. Merit’s outstanding capital stock consisted of 1,000 shares of common stock with a par value of $100 per share. For the transfer of Kee’s assets to be tax-free, what is the minimum number of shares of Merit’s stock that must be owned by Rees immediately after the exchange?

1. 500
2. 501
3. 800
4. 801

1N81#46. Roberta Warner and Sally Rogers formed the Acme Corporation on October 1, 1980. On the same date Warner paid $75,000 cash to Acme for 750 shares of its common stock. Simultaneously, Rogers received 100 shares of Acme’s common stock for services rendered. How much should Rogers include as taxable income for 1980, and what will be the basis of her stock?

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Basis of stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $0</td>
<td>$10,000</td>
</tr>
<tr>
<td>c. $10,000</td>
<td>$0</td>
</tr>
<tr>
<td>d. $10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

H. Reorganizations

2M85#54. Pursuant to a plan of corporate reorganization adopted in 1984, Myra Eber exchanged 1,000 shares of Faro Corp. common stock that she had purchased for $75,000, for 1,800 shares of Judd Corp. common stock having a fair market value of $86,000. As a result of this exchange, Eber’s recognized gain and her basis in the Judd stock should be

<table>
<thead>
<tr>
<th>Recognized gain</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $11,000</td>
<td>$86,000</td>
</tr>
<tr>
<td>b. $11,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>c. $0</td>
<td>$86,000</td>
</tr>
<tr>
<td>d. $0</td>
<td>$75,000</td>
</tr>
</tbody>
</table>

2N84#58. In connection with a plan of corporate reorganization adopted in 1984, Rae Sheen exchanged 100 shares of Bohr Corp. common stock for 300 shares of Luna Corp. common stock. Rae had purchased the Bohr stock in 1980 at $5 per share. Fair market value of the Luna stock was $9 per share on the date of the exchange. As a result of this exchange, Rae’s long-term capital gain in 1984 was

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td></td>
</tr>
<tr>
<td>b. $1,000</td>
<td></td>
</tr>
<tr>
<td>c. $1,800</td>
<td></td>
</tr>
<tr>
<td>d. $2,200</td>
<td></td>
</tr>
</tbody>
</table>

2N82#55. Pursuant to a plan of reorganization adopted in 1981, Summit Corporation exchanged 1,000 shares of its common stock and paid $40,000 cash for Hansen Corporation assets with an adjusted basis of $200,000 (fair market value of $300,000). The 1,000 shares of Summit common stock had a fair market value of $260,000 on the date of the exchange. What is the basis to Summit of the assets acquired in the exchange?

a. $200,000
b. $240,000
c. $260,000
d. $300,000

2M82#46. Pursuant to a tax-free reorganization in 1981, Sandra Peel exchanged 100 shares of Lorna Corporation for 100 shares of Wood Corp., and in addition received $1,000 cash, which was not in excess of Peel’s ratable share of Lorna’s undistributed earnings and profits. Peel paid $20,000 in 1975 for the Lorna stock. The Wood stock had a fair market value of $24,000 on the date of the exchange. What is the recognized gain to be reported by Peel in 1981?

a. $0
b. $1,000 dividend
c. $1,000 long-term capital gain
d. $5,000 long-term capital gain

2M82#53. In 1976, Celia Mueller bought a $1,000 bond issued by Disco Corporation, for $1,100. Instead of paying off the bondholders in cash, Disco issued 100 shares of preferred stock in 1981 for each bond outstanding. The preferred stock had a fair market value of $15 per share. What is the recognized gain to be reported by Mueller in 1981?

a. $0
b. $400 dividend
c. $400 long-term capital gain
d. $500 long-term capital gain

1N81#41. On July 1, 1980, in connection with a recapitalization of Yorktown Corporation, Robert Moore exchanged 1,000 shares of stock which cost him $95,000 for 1,000 shares of new stock worth $108,000 and bonds in the principal amount of $10,000 with a fair market value of $10,500. What is the amount of Moore’s recognized gain during 1980?

a. $0
b. $10,500
c. $23,000
d. $23,500

I. Liquidations and Dissolutions

2M85#42. Lark Corp. and its wholly-owned subsidiary, Day Corp., both operated on a calendar year. In January 1984 Day adopted a plan of complete liqui-
Accounting Practice

dation. Two months later, Day paid all of its liabilities and distributed its remaining assets to Lark. These assets consisted of the following:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land (at cost)</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Fair market value of the land was $30,000. Upon distribution of Day's assets to Lark, all of Day's capital stock was cancelled. Lark's basis for the Day stock was $7,000. Lark's recognized gain in 1984 on receipt of Day's assets in liquidation was

a. $0
b. $50,000
c. $53,000
d. $73,000

2M84#6. Tyson Corp. distributed marketable securities in redemption of its stock in a complete liquidation. These securities had a basis of $300,000 and a fair market value of $450,000. What gain does Tyson have as a result of the distribution?

a. $0
b. $150,000 capital gain.
c. $150,000 Section 1231 gain.
d. $150,000 ordinary gain.

2M84#15. In a corporation that has no cash and does not own any stock or securities, the one-month liquidation under Code Section 333

a. Is available only if the corporation is collapsible.
b. Can be in partial redemption of the corporation's capital stock.
c. Results in the corporation's earnings and profits being taxed as an ordinary dividend to non-corporate stockholders.
d. Is required to take effect in the same month in which the election was made.

2N83#51. At January 1, 1983, Pearl Corp. owned 90% of the outstanding stock of Sesof Corp. Both companies were domestic corporations. Pursuant to a plan of liquidation adopted by Sesof in March 1983, Sesof distributed all of its property in September 1983, in complete redemption of all its stock, when Sesof's accumulated earnings equalled $18,000. Sesof had never been insolvent. Pursuant to the liquidation, Sesof transferred to Pearl a parcel of land with a basis of $10,000 and a fair market value of $40,000. How much gain must Sesof recognize in 1983 on the transfer of this land to Pearl?

a. $0
b. $18,000
c. $27,000
d. $30,000

2M83#47. Silva Corporation adopted a one-month complete liquidation plan on July 1, 1982, when Silva's accumulated earnings and profits were $30,000. John Blum, whose basis in Silva's stock was $15,000, was Silva's sole stockholder. On July 25, 1982, all of Silva's assets were distributed to Blum in exchange for Blum's stock. These assets comprised the following:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$22,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities (fair market value)</td>
<td>37,500</td>
</tr>
<tr>
<td>Total</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

How much should Blum report as dividend income in 1982?

a. $0
b. $22,500
c. $30,000
d. $45,000

2M83#48. Carmela Corporation had the following assets on January 2, 1982, the date on which it adopted a 12-month complete liquidation plan:

<table>
<thead>
<tr>
<th>Adjusted basis</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land 75,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Inventory 43,500</td>
<td>66,000</td>
</tr>
<tr>
<td>Totals $118,500</td>
<td>$216,000</td>
</tr>
</tbody>
</table>

The land was sold on June 30, 1982, to an unrelated party at a gain of $75,000. The inventory was sold to various customers during 1982 at an aggregate gain of $22,500. On December 10, 1982, the remaining asset (cash) was distributed to Carmela's stockholders, and the corporation was liquidated. What is Carmela's recognized gain in 1982?

a. $0
b. $22,500 ordinary income.
c. $75,000 capital gain.
d. $97,500 capital gain.

2N82#59. Edgewood Corporation was liquidated in 1981 by Roberts, its sole shareholder. Pursuant to the liquidation, Roberts' stock in Edgewood was cancelled and he received the following assets on July 15, 1981:

<table>
<thead>
<tr>
<th>Basis to Edgewood</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Accounts receivable 20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Inventory 30,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Land 50,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Totals $140,000</td>
<td>$180,000</td>
</tr>
</tbody>
</table>

How much gain should be recognized by Edgewood Corporation on the liquidation?

a. $0
b. $15,000
c. $25,000
d. $40,000

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2M82#47. On October 1, 1980, Arosa Corporation adopted a plan for a 12-month, complete liquidation. Land, with an adjusted basis of $30,000 bought in 1975 for investment, was sold for $90,000 on December 10, 1980. Negotiations for the sale of this land commenced in September 1980. On November 1, 1981, Arosa distributed all of its assets to the stockholders. What is Arosa’s recognized gain in 1980 on the sale of the land?
   a. $0.
   b. $60,000 ordinary income.
   c. $60,000 long-term capital gain.
   d. $60,000 Section 1245 gain.

1N81#48. John Gerry, the sole shareholder in Rockville Corporation, elected to liquidate the corporation in a one-month liquidation which was begun and completed within the month of October 1980. Gerry received liquidating distribution during October 1980 as follows:

   - Cash of $6,000.
   - Machinery (subject to a $13,000 lien) with a fair market value of $40,000.

At the time of liquidation, the basis of Gerry’s stock investment in Rockville was $20,000, and the accumulated earnings and profits of the corporation amounted to $5,000. How much of the liquidating distribution is taxable to Gerry as ordinary income and as capital gain in 1980?

<table>
<thead>
<tr>
<th>Ordinary income</th>
<th>Capital gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$6,000</td>
</tr>
<tr>
<td>b. $5,000</td>
<td>$0</td>
</tr>
<tr>
<td>c. $5,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>d. $6,000</td>
<td>$7,000</td>
</tr>
</tbody>
</table>

J. Formation of Partnership

2M85#56. On October 1, 1984, Adam Krol received a 10% interest in the capital of Fine & Co., a partnership, for past services rendered. Fine’s net assets at October 1 had a basis of $140,000 and a fair market value of $200,000. How much ordinary income should Adam include in his 1984 return for the partnership interest transferred to him by the other partners?
   a. $20,000
   b. $14,000
   c. $6,000
   d. $0

2N84#45. On May 1, 1984, John Alda was admitted to partnership in the firm of Bartok & Benson. Alda’s contribution to capital consisted of 500 shares of stock in Asch Corp., purchased in 1973 for $20,000, and which had a fair market value of $100,000 on May 1, 1984. Alda’s interest in the partnership’s capital and profits is 25%. On May 1, 1984, the fair market value of the partnership’s net assets (after Alda was admitted) was $400,000. What was Alda’s gain in 1984 on the exchange of the Asch stock for Alda’s partnership interest?
   a. $0.
   b. $80,000 ordinary income.
   c. $80,000 long-term capital gain.
   d. $80,000 Section 1231 gain.

2M84#17. Morris Babb, sole proprietor of Babb Fabrics, hired Ken Ryan on January 1, 1981, for an agreed salary and the promise of a 10% partnership capital interest if Ryan continued in Babb’s employ until December 31, 1983. On January 1, 1984, when the enterprise’s net worth was $100,000, the partnership was formed as agreed. Ryan should treat the receipt of his partnership interest in 1984 as
   a. Nontaxable.
   b. $10,000 ordinary income.
   c. $10,000 short-term capital gain.
   d. $10,000 long-term capital gain.

2N83#53. Harry Arch, an attorney, rendered legal services in organizing an oil and gas partnership in 1983. Instead of submitting a bill for his services, Arch accepted a 10% interest in the partnership. Arch’s normal charge for the services performed would have been $10,000. The fair market value of the 10% interest received by Arch was $12,000. How much should Arch report on his 1983 income tax return?
   a. $12,000
   b. $10,000
   c. $2,000
   d. $0

2N82#58. Browne and Whelan form a partnership on January 1, 1982, agreeing to share capital and profits equally. Browne contributes $23,000 cash. Whelan contributes land with an adjusted basis to him of $10,000 and a fair market value of $25,000 on January 1, 1982. The land is subject to a $2,000 mortgage which is assumed by the partnership. Whelan’s tax basis in the partnership on January 1, 1982, should be
   a. $8,000
   b. $9,000
   c. $10,000
   d. $23,000

1N81#49. Jeffrey, the sole proprietor of a hardware business, hired Eastwood on January 1, 1977, for an agreed salary and a promise to give him a 25% ownership interest if he were still employed at the end of three years, and an additional 25% interest if he continued in the business for a second three-year period. On January 1, 1980, a partnership was formed and Eastwood received a 25% interest in the capital and profits of the business. On that date the net worth of the partnership was $60,000. What is Eastwood’s tax
basis of his partnership interest at January 1, 1980, and what amount should be added to his taxable income for 1980?

<table>
<thead>
<tr>
<th>Partnership interest</th>
<th>Addition to taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>c. $30,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>d. $30,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

K. Basis of Partner's Interest

2M85#58. The following information pertains to land contributed by Earl Mott for a 50% interest in a new partnership:

- Adjusted basis to Mott: $50,000
- Fair market value: $90,000
- Mortgage assumed by partnership: $10,000

Mott's basis for his partnership interest is

a. $40,000
b. $45,000
c. $55,000
d. $80,000

2M84#55. On July 1, 1984, Ann Arber received a 10% interest in the capital of Toty Associates, a partnership, for past services rendered. Toty's net assets at July 1, 1984, had a basis of $140,000 and a fair market value of $200,000. What income should Ann include in her 1984 income tax return for the partnership interest transferred to her by the other partners?

- a. $0
- b. $14,000 ordinary income
- c. $20,000 ordinary income
- d. $20,000 long-term capital gain

2M84#19. In 1984 Peggy Pink contributed property to a new partnership in return for a 50% interest in capital and profits. The property had a fair market value of $10,000, an adjusted basis of $6,000, and was subject to a $9,000 mortgage which was assumed by the partnership. What was Pink's basis in the partnership as a result of this contribution?

- a. $5,500
- b. $1,500
- c. $500
- d. $0

2N83#54. Ralph Elin contributed a plot of land to the partnership of Anduz & Elin. Elin's adjusted basis for this land was $50,000, and its fair market value was $75,000. Under the partnership agreement, Elin's capital account was credited with the full fair market value of the land. Anduz matched Elin's contribution with a $75,000 cash contribution to the partnership. Thus, each partner's capital account was credited with $75,000. Elin and Anduz share profits and losses equally. What is the adjusted basis of Elin's interest in the partnership?

- a. $25,000
- b. $37,500
- c. $50,000
- d. $75,000

2M83#58. On July 1, 1982, Clark acquired a 20% interest in the partnership of Davis & Denny, by contributing a parcel of land for which his basis was $8,000. At July 1, 1982, the land had a fair market value of $20,000 and was subject to a mortgage of $4,000. Payment of the mortgage was assumed by the partnership. The basis of Clark's interest in the partnership is

- a. $4,000
- b. $4,800
- c. $16,000
- d. $16,800

2M82#57. On July 1, 1981, Bertram Bryant acquired a 30% interest in Windward Company, a partnership, by contributing property with an adjusted basis of $5,000 and a fair market value of $12,000. The property was subject to a mortgage of $8,000, which was assumed by Windward. What is Bryant's basis of his interest in Windward?

- a. $0
- b. $4,000
- c. $5,000
- d. $6,400

2M82#58. On September 1, 1981, James Elton received a 25% capital interest in Bredbo Associates, a partnership, in return for services rendered plus a contribution of assets with a basis to Elton of $25,000 and a fair market value of $40,000. The fair market value of Elton's 25% interest was $50,000. How much is Elton's basis for his interest in Bredbo?

- a. $25,000
- b. $35,000
- c. $40,000
- d. $50,000

L. Determination of Partner's Taxable Income and Partner's Elections

2N84#54. The partnership of Martin & Clark sustained an ordinary loss of $84,000 in 1983. The partners, as well as the two partners, are on a calendar-year basis. The partners share profits and losses equally. At December 31, 1983, Clark had an adjusted basis of $36,000 for his partnership interest, before consideration of the 1983 loss. On his individual income tax return for 1983, Clark should deduct an (a)

- a. Ordinary loss of $36,000.
- b. Ordinary loss of $42,000.
- c. Ordinary loss of $36,000 and a capital loss of $6,000.
- d. Capital loss of $42,000.
2MB4#14. Gladys Peel owns an 80% interest in the capital and profits of the partnership of Peel & Poe. On July 1, 1983, Peel bought surplus land from the partnership at the land’s fair market value of $10,000. The partnership’s basis in the land was $16,000. For the year ended December 31, 1983, the partnership’s net income was $94,000, after recording the $6,000 loss on the sale of land. Peel’s distributive share of ordinary income from the partnership for 1983 was

a. $70,400
b. $75,200
c. $78,200
d. $80,000

2MB3#60. John Albin is a retired partner of Brill & Crum, a personal service partnership. Albin has not rendered any services to Brill & Crum since his retirement in 1975. Under the provisions of Albin’s retirement agreement, Brill & Crum is obligated to pay Albin 10% of the partnership’s net income each year. In compliance with this agreement, Brill & Crum paid Albin $25,000 in 1982. How should Albin treat this $25,000?

a. Not taxable.
b. Ordinary income.
c. Short-term capital gain.
d. Long-term capital gain.

1NB1#53. At December 31, 1979, Burns and Cooper were equal partners in a partnership with net assets having a tax basis and fair market value of $100,000. On January 1, 1980, Todd contributed securities with a fair market value of $50,000 (purchased in 1978 at a cost of $35,000) to become an equal partner in the new firm of Burns, Cooper and Todd. The partnership agreement provided that Todd would report all gain attributable to the precontribution appreciation in the securities and that postcontribution appreciation is to be shared equally by the partners. The securities were sold on December 15, 1980, for $65,000. How much of the partnership’s capital gain from the sale of these securities should be allocated to Todd?

a. $5,000
b. $10,000
c. $15,000
d. $20,000

2MB1#49. The partnership of Felix and Oscar had the following items of income during the taxable year ended December 31, 1980:

Income from operations $156,000
Tax-exempt interest income 8,000
Dividends from foreign corporations 6,000
Net rental income 12,000

What is the total ordinary income of the partnership for 1980?

a. $170,000
b. $174,000
c. $176,000
d. $182,000

2MB1#51. Charles Jordan files his income tax return on a calendar-year basis. He is the principal partner of a partnership reporting on a June 30 fiscal-year basis. Jordan’s share of the partnership’s ordinary income was $24,000 for the fiscal year ended June 30, 1979, and $72,000 for the fiscal year ended June 30, 1980. How much should Jordan report on his 1980 return as his share of taxable ordinary income from the partnership?

a. $24,000
b. $36,000
c. $48,000
d. $72,000

2MB1#52. Richard Wilson is a partner in the firm of Day and Wilson. His profit and loss sharing ratio is 50%. In 1978 he contributed a capital asset to the business with a basis to him of $40,000 and a fair market value of $30,000 to the partnership. His capital account was credited for $30,000. During 1980 the property was sold for $36,000. There were no other sales of capital assets in 1980. As a result of the sale, Wilson’s share of the partnership’s capital asset transaction is a

a. $2,000 capital loss.
b. $3,000 capital gain.
c. $4,000 capital loss.
d. $6,000 capital gain.

M. Accounting Periods of Partnership and Partners

1NB1#58. Gilroy, a calendar-year taxpayer, is a partner in the firm of Adams and Company which has a fiscal year ending June 30. The partnership agreement provides for Gilroy to receive 25% of the ordinary income of the partnership. Gilroy also receives a guaranteed payment of $1,000 monthly which is deductible by the partnership. The partnership reported ordinary income of $88,000 for the year ended June 30, 1980, and $132,000 for the year ended June 30, 1981. How much should Gilroy report on his 1980 return as total income from the partnership?

a. $25,000
b. $30,500
c. $34,000
d. $39,500
N. Partner Dealing With Own Partnership

2M85#59. Kay Shea owns an 85% interest in the capital and profits of Admor Antiques, a partnership. In 1984 Kay sold an oriental lamp to Admor for $5,000. Kay bought this lamp in 1970 for her personal use at a cost of $1,000 and had used the lamp continuously in her home until the lamp was sold to Admor. Admor purchased the lamp as inventory for sale to customers in the ordinary course of business. What is Kay's reportable gain in 1984 on the sale of the lamp to Admor?
   a. $4,000 ordinary income.
   b. $4,000 long-term capital gain.
   c. $3,400 ordinary income.
   d. $3,400 long-term capital gain.

2N82#44. Barker owns a 40% interest in the capital and profits of the Murphy and Barker partnership. During 1981 Barker sold securities to the partnership for their fair market value of $36,000. Barker's adjusted tax basis in the securities was $24,000. How much gain (before any long-term capital gain deduction) should Barker recognize on this transaction on his 1981 tax return?
   a. $0
   b. $4,800
   c. $7,200
   d. $12,000

2N82#47. In computing the ordinary income of a partnership reportable on the partnership return, a deduction is allowed for
   a. Contributions to charitable organizations.
   b. The net operating loss deduction.
   c. A net short-term capital loss.
   d. Guaranteed payments to partners.

1N81#54. On December 1, 1980, Alan Younger, a member of a three-man equal partnership, bought securities from the partnership for $27,000, their market value. The securities were acquired by the partnership for $15,000 on March 1, 1980. By what amount will this transaction increase Younger's taxable income for 1980?
   a. $0
   b. $1,600
   c. $4,000
   d. $12,000

O. Treatment of Liabilities

2M85#57. Hall and Haig are equal partners in the firm of Arosa Associates. On January 1, 1984, each partner's adjusted basis in Arosa was $40,000. During 1984 Arosa borrowed $60,000, for which Hall and Haig are personally liable. Arosa sustained an operating loss of $10,000 for the year ended December 31, 1984. The basis of each partner's interest in Arosa at December 31, 1984, was
   a. $35,000
   b. $40,000
   c. $65,000
   d. $70,000

P. Distribution of Partnership Assets

2M85#60. Ted King's adjusted basis for his partnership interest in Troy Company was $24,000. In complete liquidation of his interest in Troy, King received cash of $4,000 and realty having a fair market value of $40,000. Troy's adjusted basis for this realty was $15,000. King's basis for the realty is
   a. $9,000
   b. $15,000
   c. $16,000
   d. $20,000

2N83#58. Magda Shaw's adjusted basis for her partnership interest in Shaw & Zack was $60,000. In complete liquidation of her interest in Shaw & Zack, Shaw received cash of $44,000 plus the following assets:

<table>
<thead>
<tr>
<th>Adjusted basis to</th>
<th>Land — Tract “A”</th>
<th>$24,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Land — Tract “B”</td>
<td>8,000</td>
</tr>
</tbody>
</table>

How much is Shaw's basis for Tract "B"?
   a. $16,000
   b. $15,000
   c. $8,000
   d. $4,000

2M83#54. Fred Elk's adjusted basis of his partnership interest in Arias & Nido was $30,000. Elk received a current nonliquidating distribution of $12,000 cash, plus property with a fair market value of $26,000 and an adjusted basis to the partnership of $24,000. How much is Elk's basis for the distributed property?
   a. $18,000
   b. $24,000
   c. $26,000
   d. $30,000

2M83#55. Daly & Shaw, a partnership, has an H.R. 10 plan. Daly's interest in the partnership is 95%, while Shaw's interest in the partnership is 5%. During 1982, Daly borrowed $3,800 from the plan, and Shaw borrowed $200 from the plan. How much of these loans will be automatically treated by the Internal Revenue Service as distributions from the plan?
   a. $0
   b. $200
   c. $3,800
   d. $4,000
Selected Questions

2M83#59. At December 31, 1982, Max Curcio’s adjusted basis in the partnership of Maduro & Motta was $36,000. On December 31, 1982, Maduro & Motta distributed cash of $6,000 and a parcel of land to Curcio in liquidation of Curcio’s entire interest in the partnership. The land had an adjusted basis of $18,000 to the partnership and a fair market value of $42,000 at December 31, 1982. How much is Curcio’s basis in the land?
   a. $0
   b. $12,000
   c. $30,000
   d. $36,000

Q. Termination of Partnership

2N84 Items 42 and 43 are based on the following data:

The partnership of Hager, Mazer & Slagle had the following cash basis balance sheet at December 31, 1983:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$51,000</td>
<td>$51,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>—</td>
<td>210,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$51,000</td>
<td>$261,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable</td>
</tr>
<tr>
<td>Capital accounts</td>
</tr>
<tr>
<td>Hager</td>
</tr>
<tr>
<td>Mazer</td>
</tr>
<tr>
<td>Slagle</td>
</tr>
<tr>
<td>Totals</td>
</tr>
</tbody>
</table>

Slagle, an equal partner, sold his partnership interest to Burns, an outsider, for $77,000 cash on January 1, 1984. In addition, Burns assumed Slagle’s share of partnership liabilities.

42. How much ordinary income should Slagle report in his 1984 income tax return on the sale of his partnership interest?
   a. $0
   b. $10,000
   c. $70,000
   d. $77,000

43. What was the total amount realized by Slagle on the sale of his partnership interest?
   a. $67,000
   b. $70,000

c. $77,000
d. $87,000

2M83#53. On June 30, 1982, James Roe sold his interest in the calendar-year partnership of Roe & Doe for $30,000. Roe’s adjusted basis in Roe & Doe at June 30, 1982, was $7,500 before apportionment of any 1982 partnership income. Roe’s distributive share of partnership income up to June 30, 1982, was $22,500. Roe acquired his interest in the partnership in 1970. How much long-term capital gain should Roe report in 1982 on the sale of his partnership interest?
   a. $0
   b. $15,000
   c. $22,500
   d. $30,000

2M83#56. Axel, Banner & Carr, a calendar-year partnership, had the following partners since 1970:

<table>
<thead>
<tr>
<th>Partnership interest (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Axel</td>
</tr>
<tr>
<td>Banner</td>
</tr>
<tr>
<td>Carr</td>
</tr>
</tbody>
</table>

On October 20, 1982, Axel and Banner sold their partnership interests to Carr and withdrew from participation in the partnership’s affairs. At what date was the partnership terminated for tax purposes?
   a. October 1, 1982.
   b. October 20, 1982.

2M83#57. David Beck and Walter Crocker were equal partners in the calendar-year partnership of Beck & Crocker. On July 1, 1982, Beck died. Beck’s estate became the successor in interest and continued to share in Beck & Crocker’s profits until Beck’s entire partnership interest was liquidated on April 30, 1983. At what date was the partnership considered terminated for tax purposes?

2N82#60. On November 30, 1981, Diamond’s adjusted basis for his one-third interest in the capital and profits of Peterson and Company was $95,000 ($80,000 capital account plus $15,000 share of partnership liabilities). On that date Diamond sold his partnership interest to Girard for $120,000 cash and the assumption
Accounting Practice

of Diamond's share of the partnership liabilities. What amount and type of gain should Diamond recognize in 1981 from the sale of his partnership interest?

<table>
<thead>
<tr>
<th>Amount</th>
<th>Type of gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$25,000</td>
<td>Ordinary income</td>
</tr>
<tr>
<td>$25,000</td>
<td>Capital gain</td>
</tr>
<tr>
<td>$40,000</td>
<td>Ordinary income</td>
</tr>
<tr>
<td>$40,000</td>
<td>Capital gain</td>
</tr>
</tbody>
</table>

1N81#56. On April 1, 1980, George Hart, Jr., acquired a 25% interest in the Wilson, Hart and Company partnership by gift from his father. The partnership interest had been acquired by a $50,000 cash investment by Hart, Sr., on July 1, 1965. The tax basis of Hart, Sr.'s partnership interest was $60,000 at the time of the gift. Hart, Jr., sold the 25% partnership interest for $85,000 on December 17, 1980. What type and amount (before consideration of the capital gain deduction) of capital gain should Hart, Jr., report on his 1980 tax return?

a. A long-term capital gain of $25,000.
b. A short-term capital gain of $25,000.
c. A long-term capital gain of $35,000.
d. A short-term capital gain of $35,000.
I.  Presentation of Financial Statements or Worksheets

C.  Statement of Changes in Financial Position

2M83#26 b  2M81#25 c  2M81#28 c
1N81# 18 d  2M81#26 d  2M81#29 d
1N81# 20 c  2M81#27 d  2M81#30 d

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

A.  Cash, Marketable Securities, and Investments

1N84#  4 a  1N84#  5 d  1N84# 19 c
1N83# 21 b  1N83# 22 a  1N82#  6 d
1N83# 22 b  1N82#  3 d  1N82#18 a
1N84#  1 a  1M82#  3 d  1N84#13 c
1N84#  2 d  1M82#  4 b  1N84#15 b
1M84#  1 d  1M82#  8 d  1N84#20 c
1M84#  2 b  2N81#  1 b  1M84#16 a
1M84#  3 c  2N81#  8 d  1M84#21 b
1M84#  4 a  2N81#17 d  1M84# 5 b
1M83#  2 a  2N81#19 b  1M84#  8 d
1M83#  3 c  1M84#  9 d  1M85#12 b
1M83#20 b  1M84#10 c  1M85#19 c
2M83#10 b  1M84#11 d  1M85#20 c
1N82#  2 b  1N85#  8 d  1N84#13 c
2N82#  8 d  1M85#10 c  1N84#14 b
1M82#  6 c  1M85#14 b  1N84#17 b
1M82# 13 b  1N83#  3 c  1N84#14 d
2M82#  2 c  1M84#  6 c  1N83#  3 d
2M82#10 c  1N84#  7 a  1N83#23 c
1N84#  8 a  1N83#25 d  1N83# 28 d
1N81#  3 d  1N83#27 c  1M84#15 c
1M84#  6 b  1N83# 35 b  1M84#17 b
2N81#  2 c  1M83#  5 b  1M84#18 a
2N81#  7 c  2M83#  1 c  1N83# 40 a
2N81#11 b  2M83# 14 c  1M83#  4 c
1N83# 20 c  2M83#21 b  1M83#  6 d
2N82#11 b  2M83#23 d  2M82#13 c
1N81# 13 b  2M83#31 c  1N81# 12 c
2N81#15 d  2M83#32 a  2N81#  5 c
1N85#  6 a  2N81#16 b  2N81#33 d
1M85#  7 a  1N82# 13 a  2N81#30 c
1M85#  9 d  2N82#  2 b  1M81#19 a
1N84#  3 d  2M81#14 a  1M82#  2 b
2M81#35 c  1M82#  9 c

B.  Receivables and Accruals

1M85#  5 c  2M82#  3 a  1N81# 13 b
2N81#13 b  2M83#32 a  2N81#  5 c
1N85# 15 d  2N82#  3 c  1N81# 12 c
1M85#  6 a  2M83#33 d  1N81# 13 a
1M85#  7 a  1N82#  2 b  2N81#  5 c
1M85#  9 d  2N82#  2 b  1M81#19 a
1N84#  3 d  2M81#14 a  1M82#  2 b
2M81#35 c  1M82#  9 c

E.  Intangibles and Other Assets

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1N84#13 c  1N83#  3 d  1N84#14 c
1N84#11 d  1N83#23 c  1N83#  3 d
1N84#15 b  1N83#25 d  1N83#35 b
1M84#12 c  1N83#27 c  1M84#18 a
1M84#15 c  1N83#28 d  1M83#  4 c
1M84#17 b  1N83#30 b  1M83#  6 d
1M84#18 a  2M83#21 b  2M82#13 c
1M83#  4 d  2M83#23 d  1N81#12 c
1N83# 40 a  1N82# 13 a  1N81#  5 c
2M83#  1 c  2M83#14 c  2N81#30 c
2M83# 31 c  2M83#12 a  1M81#19 a
2M83#32 a  2N82#  2 b  1M81#19 a
2M83#33 d  2N81#  5 c  1M81#19 a
2M81#16 b  1N82#  2 b  2N81#30 c
2M81#14 a  1M82#  2 b  1M81#19 a
2M81#35 c  1M82#  9 c
III. Valuation, Recognition, and Presentation of Liabilities in Conformity With
Generally Accepted Accounting Principles

A. Payables and
Accruals
2M81#31 d
2M81#32 c
B. Deferred Revenues
2M85# 1 b
2M85# 2 d
2M85# 7 d
1N84# 21 b
1M84#16 c
1M84#19 b
1M84#20 d
1N83# 24 c
1N83# 30 a
1N83# 36 d
2N83# 3 d
1M83# 1 d
1M83# 7 d
1M83# 9 b
1M83#13 c
2N82# 12 a
2N82# 20 b
1M81# 3 d
1M81# 7 c
1M81#15 a
2M81# 9 d

C. Deferred Income Tax
Liabilities
1M85# 14 d
1M85#15 b
1N84# 26 b
1N84# 27 c
2M83# 34 d
1N82# 4 a
2N82# 5 c
2M81# 20 b
2M81#22 b
1N82# 9 a
2N82# 1 b
1N81#11 c
2N81# 18 c
1M85#16 d
2N81# 21 d
2N81#22 c

D. Capitalized Lease
Liability
1M84#24 c
1N83# 33 d
1M82# 8 a
1M81#16 b
2M81#21 d
1N84# 24 d
1M84#25 a
1M84#30 c
1M84#40 c
1N83# 2 a
1N83# 5 d
1N83# 7 c
1M83# 8 b
1M83#11 c
2M81#19 b
2M85# 4 b
2M85# 5 d
2M85# 3 b
1N84# 25 a
1N84# 26 b
1M83#10 b
1N81# 1 c
2N81# 12 a
2M81# 7 b

E. Bonds Payable
2M83#20 c
2N82# 7 a
2N82# 14 b
2N82# 20 c
2M82#15 a
1N81# 8 a
2N81# 29 c
2N81# 21 d

F. Contingent Liabilities
and Commitments

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With
Generally Accepted Accounting Principles

A. Preferred and
Common Stock
1M85# 14 d
1M85#15 b
1N84# 26 b
1N84# 27 c
2M83# 34 d
1N82# 4 a
2N82# 5 c
2M81# 20 b
2M81#22 b
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2N82# 1 b
1N81#11 c
2N81# 18 c
1M85#16 d
2N81# 21 d
2N81#22 c

B. Additional Paid-in
Capital

C. Retained Earnings
and Dividends
1M85# 17 a
1M85#18 a
1M85#24 d
1M84#28 c
1N84# 29 a
1N84# 32 a
2N83# 6 b
2M83# 5 a
2M81#22 b

D. Treasury Stock and
Other Contra
Accounts
1M85#25 a
1M83#15 c
1N82# 10 b
2M81# 6 a
2N81#36 d
2N81# 37 c

E. Stock Options,
Warrants, and Rights
1N84# 30 c
1N82# 17 b
2M81#10 a
2M81#11 b
2M81#12 c
2N81#25 c
2N81#26 a
2N81# 27 d

F. Reorganization and
Change in Entity
1M85#21 b
1N84# 31 b
1M85#22 b
1M85#26 c
1N84# 18 b
1M84# 34 c
2M83#11 c
2N81# 25 c
2N81# 26 a
2N81# 27 d

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
1M85#29 c
1M85#30 d
1M85#31 b
1M85#32 b
1M85#33 b
1M85#34 a
1M85#39 b
1M85#50 c
1N84# 38 c

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### VI. Other Financial Topics

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**Unofficial Answers**
### VII. Cost Accumulation, Planning, and Control

#### A. Nature of Cost Elements

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#### B. Process and Job Order Costing

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| C. Standard Costing

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**AP-148**
Unofficial Answers

VIII. Not-for-Profit and Governmental Accounting

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B. Types of Funds and Fund Accounts

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C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

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D. Various Types of Not-for-Profit and Governmental Organizations

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IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income

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B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

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Accounting Practice

G. Statute of Limitations

H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

Partnership SN.

D. Liabilities

G. Tax-Free Incorporation

L. Determination of Partner’s Taxable Income and Partner’s Elections

M. Accounting Periods of Partnership and Partners

N. Partner Dealing With Own Partnership

O. Treatment of Liabilities

P. Distribution of Partnership Assets

Q. Termination of Partnership

R. Personal Accounting

S Corporations

D. Personal Holding Companies

E. Accumulated Earnings Tax

F. Distributions

J. Formation of Partnership

K. Basis of Partner’s Interest

X. Federal Taxation—Corporations, Partnerships, and Exempt Organizations

A. Determination of Taxable Income or Loss

2N85#50 a

B. Tax Computations and Credits

2M85#45 b

2M85#46 a

2M85#47 d

2M85#49 d

2M85#50 a

2M85#51 b

2M85#52 c

2M85#46 a

2M85#47 b

2M85#48 c

2M85#49 d

2M85#51 d

2M85#46 c

2M85#53 a

2M85#56 b

2M85#58 d

2M85#1 b

2M85#2 d

2M85#3 d

2M85#5 b

2M84# 8 c

2M84#13 a

2N83# 44 d

2N83# 45 a

2N83# 47 d

2N83# 48 a

2N83# 50 d

2N83# 51 a

2N83# 52 c

2N83# 52 a

2N82# 41 b

2N82# 42 a

2N82# 43 d

2N82# 46 b

2N82# 50 b

2N82# 51 a

2N82# 53 c

2N82# 42 d

2N82# 49 c

2N82# 50 a

1N81# 42 b

1N81# 43 b

1N81# 45 a

1N81# 47 c

1N81# 50 c

2N84# 27 a

2N83# 25 a

2M84# 26 b

2M84# 27 b

2N83# 25 d

2N84# 27 a

2M84# 53 c

2N84# 50 a

2M84# 9 b

2M84# 10 a

2N83# 60 c

2N82# 49 c

2M81# 57 d

2N84# 59 b

2M83# 54 c

2M83# 58 b

2M82# 57 a

2M82# 58 b

2N83# 54 a

2M83# 60 b

1N81# 53 d

1N81# 59 b

2M81# 49 b

2M81# 51 d

2M81# 52 a

2M85# 54 d

2N84# 58 a

2N82# 55 b

2M82# 46 b

2M82# 53 a

1N81# 41 b

2M85# 42 a

2M84# 6 a

2N84# 15 c

2N83# 51 a

2M83# 47 c

2N83# 48 b

2M82# 59 a

2M82# 47 c

1N81# 48 c

2N85# 44 c

2N84# 44 b

2M84# 18 c

2N83# 57 d

2N83# 41 a

2M81# 60 a

2N83# 53 a

2N82# 58 b

1N81# 49 b

2N84# 42 c

2N84# 43 d

2M83# 53 a

2M83# 56 b

2M83# 57 a

2N82# 60 d

1N81# 56 a

AP-150
PROBLEMS — SELECTED QUESTIONS

1. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1984
Number 5 (Estimated time — 40 to 50 minutes)

Presented below is information pertaining to Ward Specialty Foods, a calendar-year sole proprietorship, maintaining its books on the cash basis during the year. At year-end, however, Mary Ward's accountant adjusts the books to the accrual basis only for sales, purchases, and cost of sales, and records depreciation to more clearly reflect the business income for income tax purposes.

Ward Specialty Foods
TRIAL BALANCE
December 31, 1983

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$18,500</td>
</tr>
<tr>
<td>Accounts receivable, 12/31/82</td>
<td>4,500</td>
</tr>
<tr>
<td>Inventory, 12/31/82</td>
<td>20,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
</tr>
<tr>
<td>Accumulated depreciation, 12/31/82</td>
<td>$9,000</td>
</tr>
<tr>
<td>Accounts payable, 12/31/82</td>
<td>4,800</td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>850</td>
</tr>
<tr>
<td>Mary Ward, drawings</td>
<td>24,000</td>
</tr>
<tr>
<td>Mary Ward, capital, 12/31/82</td>
<td>33,650</td>
</tr>
<tr>
<td>Sales</td>
<td>187,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>82,700</td>
</tr>
<tr>
<td>Salaries</td>
<td>29,500</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>2,900</td>
</tr>
<tr>
<td>Rent</td>
<td>8,400</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>3,900</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,400</td>
</tr>
<tr>
<td>Utilities</td>
<td>3,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$235,300</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$235,300</strong></td>
</tr>
</tbody>
</table>

During 1983 Ward signed a new eight-year lease for the store premises and is in the process of negotiating a loan for remodeling purposes. The bank requires Ward to present financial statements for 1983 prepared on the accrual basis. During the course of a compilation engagement, Ward's accountant obtained the following additional information:

1. Amounts due from customers totaled $7,900 at December 31, 1983.
2. A review of the receivables at December 31, 1983, disclosed that an allowance for doubtful accounts of $1,100 should be provided. Ward had no bad debt losses from inception of the business through December 31, 1983.
3. The inventory amounted to $23,000 at December 31, 1983, based on physical count of goods priced at cost. No reduction to market was required.
4. On signing the new lease on October 1, 1983, Ward paid $8,400 representing one year's rent in advance for the lease year ending October 1, 1984. The $7,500 annual rental under the old lease was paid on October 1, 1982, for the lease year ended October 1, 1983.
5. On April 1, 1983, Ward paid $2,400 to renew the comprehensive insurance coverage for one year. The premium was $2,160 on the old policy which expired on April 1, 1983.
6. Depreciation on equipment was computed at $5,800 for 1983.
7. Unpaid vendors' invoices for food purchases totaled $8,800 at December 31, 1983.
8. Accrued expenses at December 31, 1982, and December 31, 1983, were as follows:

<table>
<thead>
<tr>
<th></th>
<th>12/31/82</th>
<th>12/31/83</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll taxes</td>
<td>$250</td>
<td>$400</td>
</tr>
<tr>
<td>Salaries</td>
<td>375</td>
<td>510</td>
</tr>
<tr>
<td>Utilities</td>
<td>275</td>
<td>450</td>
</tr>
</tbody>
</table>

Required:

Go to page AP-152 and remove tear-out worksheet.

a. Complete the tear-out worksheet to convert the trial balance of Ward Specialty Foods to the accrual basis for the year ended December 31, 1983. Journal entries are not required to support your adjustments. Include the completed tear-out worksheet in the proper sequence with other answer sheets.

b. Prepare the statement of changes in Mary Ward, capital, for the year ended December 31, 1983.
WORKSHEET TO CONVERT
TRIAL BALANCE TO ACCRUAL BASIS
December 31, 1983

<table>
<thead>
<tr>
<th></th>
<th>Cash Basis</th>
<th>Adjustments</th>
<th>Accrual Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
</tr>
<tr>
<td>Cash</td>
<td>$18,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allow. for doubtful accts.</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accum. depreciation</td>
<td></td>
<td>$9,000</td>
<td></td>
</tr>
<tr>
<td>Prepaid rent</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
<td>4,800</td>
<td></td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>—</td>
<td>850</td>
<td></td>
</tr>
<tr>
<td>Ward, drawings</td>
<td>24,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ward, capital</td>
<td></td>
<td>33,650</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>187,000</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>82,700</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income summary — inventory</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>29,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>2,900</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>8,400</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Miscellaneous exp.</td>
<td>3,900</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>2,400</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>3,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Doubtful accounts exp.</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$235,300</td>
</tr>
</tbody>
</table>

AP-152
Bryant is in the process of negotiating a loan for expansion purposes and the bank has requested audited financial statements. During the course of the audit, the following additional information was obtained:

1. The investment portfolio consists of short-term investments in marketable equity securities with a total market valuation of $55,000 as of November 30, 1982.

2. Based on an aging of the accounts receivable as of November 30, 1982, it was estimated that $36,000 of the receivables will be uncollectible.

3. Inventories at November 30, 1982, did not include work-in-process inventory costing $12,000 sent to an outside processor on November 29, 1982.

4. A $3,000 insurance premium paid on November 30, 1982, on a policy expiring one year later was charged to insurance expense.

5. Bryant adopted a pension plan on June 1, 1982, for eligible employees to be administered by a trustee. Based upon actuarial computations, the first 12 months’ normal pension plan cost was estimated at $45,000.

6. On June 1, 1982, a production machine purchased for $24,000 was charged to repairs and maintenance. Bryant depreciates machines of this type on the straight-line method over a five-year life, with no salvage value, for financial and tax purposes.

7. Research and development costs of $150,000 were incurred in the development of a patent which Bryant expects to be granted during the fiscal year ended November 30, 1983. Bryant initiated a five-year amortization of the $150,000 total cost during the fiscal year ended November 30, 1982.

8. During December 1982 a competitor company filed suit against Bryant for patent infringement claiming $200,000 in damages. Bryant’s legal counsel believes that an unfavorable outcome is probable. A reasonable estimate of the court’s award to the plaintiff is $50,000.

9. The 40% effective tax rate was determined to be appropriate for calculating the provision for income taxes for the fiscal year ended November 30, 1982. Ignore computation of deferred portion of income taxes.

Required:

Go to page AP-154 and remove tear-out worksheet.

Complete the tear-out worksheet to prepare a corrected balance sheet of Bryant Corporation as of November 30, 1982, and a corrected statement of income for the year ended November 30, 1982. Formal statements and journal entries are not required. Supporting computations should be in good form. Include the completed tear-out worksheet in the proper sequence and turn in with other answer sheets.
Bryant Corporation
Worksheet for Balance Sheet and Income Statement
November 30, 1982

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Unadjusted Balance</th>
<th>Adjustments</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 150,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketable securities, at cost</td>
<td>60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>450,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(59,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>430,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant &amp; equipment</td>
<td>426,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(40,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Research &amp; development costs</td>
<td>120,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$1,552,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Liabilities & Stockholders' Equity: |                |             |                  |
| Accounts payable & accrued expenses | (592,000) |             | $(1,552,000)     |
| Income taxes payable             | (224,000)        |             |                  |
| Common stock                     | (400,000)         |             |                  |
| Retained earnings                | (336,000)         |             |                  |
| **Total Liabilities & Stockholders' Equity:** | $(1,552,000) |             |                  |

**Statement of Income**

- Net sales $ (2,950,000)
- Cost of sales 1,670,000
- Selling & administrative expenses 650,000
- Depreciation expense 40,000
- Research & development expense 30,000
- Provision for income taxes 224,000
- **Net income** $ (336,000)
Before closing the books for the year ended December 31, 1984, Glenn Corporation, a Kansas corporation, prepared the following adjusted trial balance:

**Adjusted Trial Balance**
**December 31, 1984**

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>550,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>1,650,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>2,750,000</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>13,550,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
</tr>
<tr>
<td>Cash surrender value on officers’ life insurance</td>
<td>65,000</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>1,550,000</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>200,000</td>
</tr>
<tr>
<td>Deferred income tax</td>
<td>150,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>4,375,000</td>
</tr>
<tr>
<td>Retained earnings, 1/1/84</td>
<td>3,300,000</td>
</tr>
<tr>
<td>Net sales</td>
<td>12,500,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>7,500,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>2,425,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>245,000</td>
</tr>
<tr>
<td>Gain on sale of long-term investments</td>
<td></td>
</tr>
<tr>
<td>Income tax expense</td>
<td>600,000</td>
</tr>
<tr>
<td>Loss on litigation settlement</td>
<td>450,000</td>
</tr>
<tr>
<td>Loss due to earthquake damage</td>
<td>950,000</td>
</tr>
<tr>
<td><strong>$30,735,000</strong></td>
<td><strong>$30,735,000</strong></td>
</tr>
</tbody>
</table>

Other financial data for the year ended December 31, 1984:

**Federal income tax**
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated tax payments</td>
<td>$400,000</td>
</tr>
<tr>
<td>Accrued</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total charged to income tax expense (estimated)</td>
<td>$600,000*</td>
</tr>
</tbody>
</table>

Tax rate on all types of taxable income

40%

*Does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.

**Timing difference**
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation per tax return</td>
<td>$760,000</td>
</tr>
<tr>
<td>Depreciation per books</td>
<td>580,000</td>
</tr>
</tbody>
</table>

**Permanent difference**
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums on officers’ life insurance</td>
<td>140,000</td>
</tr>
</tbody>
</table>
**Accounting Practice**

**Capital structure**
Common stock, par value $10 per share, traded on a national exchange:

<table>
<thead>
<tr>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of shares outstanding at 1/1/84</td>
</tr>
<tr>
<td>Number of shares issued on 3/30/84 as a 10% stock dividend</td>
</tr>
<tr>
<td>Number of shares sold for $25 per share on 6/30/84</td>
</tr>
<tr>
<td>Number of shares outstanding at 12/31/84</td>
</tr>
</tbody>
</table>

**Required:**

a. Using the multiple-step format, prepare a formal income statement for Glenn for the year ended December 31, 1984. All components of income tax expense should be appropriately shown.

b. Prepare a schedule to reconcile net income to taxable income reportable on Glenn’s tax return for 1984.

**2M82**

**Number 4 (Estimated time — 45 to 55 minutes)**

The following information pertains to Woodbine Circle Corporation:

**Adjusted Trial Balance**
**December 31, 1981**

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$500,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>15,100,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$4,900,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>1,400,000</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>100,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Common stock ($1 par value)</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>6,100,000</td>
</tr>
<tr>
<td>Retained earnings, 1/1/81</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Sales — regular</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Sales — AL Division</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Interest on municipal bonds</td>
<td>100,000</td>
</tr>
<tr>
<td>Cost of sales — regular</td>
<td>6,200,000</td>
</tr>
<tr>
<td>Cost of sales — AL Division</td>
<td>900,000</td>
</tr>
<tr>
<td>Administrative expenses — regular</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Administrative expenses — AL Division</td>
<td>300,000</td>
</tr>
<tr>
<td>Interest expense — regular</td>
<td>210,000</td>
</tr>
<tr>
<td>Interest expense — AL Division</td>
<td>140,000</td>
</tr>
<tr>
<td>Loss on disposal of AL Division</td>
<td>250,000</td>
</tr>
<tr>
<td>Gain on repurchase of bonds payable</td>
<td>300,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>400,000</td>
</tr>
</tbody>
</table>

**$30,000,000**

**$30,000,000**

**Other financial data for the year ended December 31, 1981:**

**Federal income taxes**

- Paid on Federal Tax Deposit
  - Forms 503 | $300,000 |
  - Accrued | 100,000 |
- Total charged to income tax expense (estimated) | $400,000* |

*Does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes

- Income per tax return | $2,150,000 |
- Tax rate on all types of taxable income | 40% |

**Timing difference**

- Depreciation, per financial statements | $600,000 |
- Depreciation, per tax return | 750,000 |

**Permanent difference**

- Interest on municipal bonds | $100,000 |

**Discontinued operations**

On September 30, 1981, Woodbine sold its Auto Leasing (AL) Division for $4,000,000. Book value of this business segment was $4,250,000 at that date. For financial statement purposes, this sale was considered as discontinued operations of a segment of a business. Since there was no phase-out period, the measurement date was September 30, 1981.

**Liabilities**

On June 30, 1981, Woodbine repurchased $1,000,000 carrying value of its long-term bonds for $700,000. All other liabilities mature in 1982.

**Capital structure**

Common stock, par value $1 per share, traded on the New York Stock Exchange:
Selected Questions

Number of shares outstanding at 1/1/81 900,000
Number of shares sold for $8 per share on 6/30/81 200,000
Number of shares outstanding at 12/31/81 1,100,000

Required: Using the multiple-step format, prepare a formal income statement for Woodbine for the year ended December 31, 1981, together with the appropriate supporting schedules. Recurring and nonrecurring items in the income statement should be properly separated. All income taxes should be appropriately shown.

C. Statement of Changes in Financial Position

1M84 Number 4 (Estimated time — 45 to 55 minutes)
Presented below are the balance sheet accounts of Bergen Corporation as of December 31, 1983 and 1982.

<table>
<thead>
<tr>
<th>Assets</th>
<th>1983</th>
<th>1982</th>
<th>Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$541,000</td>
<td>$308,000</td>
<td>$233,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>585,000</td>
<td>495,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>895,000</td>
<td>780,000</td>
<td>115,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>2,021,000</td>
<td>1,583,000</td>
<td>438,000</td>
</tr>
<tr>
<td>Land</td>
<td>350,000</td>
<td>250,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>1,060,000</td>
<td>720,000</td>
<td>340,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(295,000)</td>
<td>(170,000)</td>
<td>(125,000)</td>
</tr>
<tr>
<td>Leased equipment under capital lease</td>
<td>158,000</td>
<td>—</td>
<td>158,000</td>
</tr>
<tr>
<td>Marketable investment securities, at cost</td>
<td>—</td>
<td>75,000</td>
<td>(75,000)</td>
</tr>
<tr>
<td>Investment in Mason, Inc., at cost</td>
<td>180,000</td>
<td>180,000</td>
<td>—</td>
</tr>
<tr>
<td>Total assets</td>
<td>$3,474,000</td>
<td>$2,638,000</td>
<td>$836,000</td>
</tr>
</tbody>
</table>

Liabilities and Stockholders' Equity

<table>
<thead>
<tr>
<th>Liabilities and Stockholders' Equity</th>
<th>1983</th>
<th>1982</th>
<th>Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current portions of long-term debt</td>
<td>$159,000</td>
<td>$ —</td>
<td>$159,000</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>760,000</td>
<td>823,000</td>
<td>(63,000)</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>919,000</td>
<td>823,000</td>
<td>96,000</td>
</tr>
<tr>
<td>Note payable, long-term</td>
<td>300,000</td>
<td>—</td>
<td>300,000</td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>124,000</td>
<td>—</td>
<td>124,000</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>500,000</td>
<td>500,000</td>
<td>—</td>
</tr>
<tr>
<td>Unamortized bond premium</td>
<td>16,000</td>
<td>18,000</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>60,000</td>
<td>45,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Common stock, par value $20</td>
<td>640,000</td>
<td>600,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>304,000</td>
<td>244,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>611,000</td>
<td>408,000</td>
<td>203,000</td>
</tr>
<tr>
<td>Total liabilities and stockholders' equity</td>
<td>$3,474,000</td>
<td>$2,638,000</td>
<td>$836,000</td>
</tr>
</tbody>
</table>

Additional information:
- On January 2, 1983, Bergen sold all of its marketable investment securities for $95,000 cash.
- On March 10, 1983, Bergen paid a cash dividend of $30,000 on its common stock. No other dividends were paid or declared during 1983.

AP-157
Accounting Practice

1N84
Number 4 (cont.)

- On April 15, 1983, Bergen issued 2,000 shares of its common stock for land having a fair value of $100,000.
- On May 25, 1983, Bergen borrowed $450,000 from an insurance company. The underlying promissory note bears interest at 15% and is payable in three equal annual installments of $150,000. The first payment is due on May 25, 1984.
- On July 1, 1983, Bergen sold equipment costing $52,000, with a book value of $28,000, for $33,000 cash.
- On September 1, 1983, Bergen paid a $20,000 additional tax assessment for 1982 due to an error in tax calculation discovered by the Internal Revenue Service. This payment was appropriately recorded by Bergen as a prior period adjustment.
- On December 31, 1983, Bergen leased equipment from Tilden Company, for a ten-year period. Equal payments under the lease are $25,000 and are due on December 31 each year. The first payment was made on December 31, 1983. The present value at December 31, 1983, of the ten lease payments is $158,000. Bergen appropriately recorded the lease as a capital lease. The $25,000 lease payment due on December 31, 1984, will consist of $9,000 principal and $16,000 interest.
- Bergen's net income for 1983 is $253,000.
- Bergen owns a 10% interest in the voting common stock of Mason, Inc., which is appropriately accounted for by the cost method. Mason reported net income of $120,000 for the year ended December 31, 1983, and paid a common stock dividend of $55,000 during 1983.

Required:
Using the working capital approach, prepare a statement of changes in financial position of Bergen Corporation for the year ended December 31, 1983. A worksheet is not required. Do not prepare a schedule of changes in working capital.

1N82
Number 4 (Estimated time — 45 to 55 minutes)

Presented below are the balance sheets of Farrell Corporation as of December 31, 1981 and 1980, and the statement of income and retained earnings for the year ended December 31, 1981.

Farrell Corporation
BALANCE SHEETS
December 31, 1981 and 1980

<table>
<thead>
<tr>
<th>Assets</th>
<th>1981</th>
<th>1980</th>
<th>Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$275,000</td>
<td>$180,000</td>
<td>$95,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>295,000</td>
<td>305,000</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Inventories</td>
<td>549,000</td>
<td>431,000</td>
<td>118,000</td>
</tr>
<tr>
<td>Investment in Hall, Inc., at equity</td>
<td>73,000</td>
<td>60,000</td>
<td>13,000</td>
</tr>
<tr>
<td>Land</td>
<td>350,000</td>
<td>200,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>624,000</td>
<td>606,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>(139,000)</td>
<td>(107,000)</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>16,000</td>
<td>20,000</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Total assets</td>
<td>$2,043,000</td>
<td>$1,695,000</td>
<td>$348,000</td>
</tr>
</tbody>
</table>

AP-158
Selected Questions

**Liabilities and Stockholders' Equity**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount 1</th>
<th>Amount 2</th>
<th>Amount 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>$604,000</td>
<td>$563,000</td>
<td>$41,000</td>
</tr>
<tr>
<td>Note payable, long-term</td>
<td>150,000</td>
<td>—</td>
<td>150,000</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>160,000</td>
<td>210,000</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>41,000</td>
<td>30,000</td>
<td>11,000</td>
</tr>
<tr>
<td>Common stock, par value $10</td>
<td>480,000</td>
<td>400,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>226,000</td>
<td>175,000</td>
<td>51,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>432,000</td>
<td>334,000</td>
<td>98,000</td>
</tr>
<tr>
<td>Treasury stock, at cost</td>
<td>—</td>
<td>(17,000)</td>
<td>17,000</td>
</tr>
<tr>
<td>Total liabilities and stockholders' equity</td>
<td>$2,043,000</td>
<td>$1,695,000</td>
<td>$348,000</td>
</tr>
</tbody>
</table>

**Farrell Corporation**

**STATEMENT OF INCOME AND RETAINED EARNINGS**

*For the Year Ended December 31, 1981*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,950,000</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>1,150,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>505,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>53,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>242,000</td>
</tr>
<tr>
<td>Other (income) expense:</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>15,000</td>
</tr>
<tr>
<td>Equity in net income of Hall, Inc.</td>
<td>(13,000)</td>
</tr>
<tr>
<td>Loss on sale of equipment</td>
<td>5,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>4,000</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>231,000</td>
</tr>
<tr>
<td>Income taxes:</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>79,000</td>
</tr>
<tr>
<td>Deferred</td>
<td>11,000</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>90,000</td>
</tr>
<tr>
<td>Net income</td>
<td>141,000</td>
</tr>
<tr>
<td>Retained earnings, January 1, 1981</td>
<td>334,000</td>
</tr>
<tr>
<td>Cash dividends, paid August 14, 1981</td>
<td>475,000</td>
</tr>
<tr>
<td>Retained earnings, December 31, 1981</td>
<td>$ 432,000</td>
</tr>
</tbody>
</table>

**Additional information:**

- On June 1, 1981, individuals holding $50,000 face value of Farrell’s bonds exercised their conversion privilege. Each of the 50 bonds was converted into 40 shares of Farrell’s common stock.
- On July 1, 1981, Farrell purchased equipment for $63,000 cash.
- On December 31, 1981, land with a fair market value of $150,000 was purchased through the issuance of a long-term note in the amount of $150,000. The note bears interest at the rate of 15% and is due on December 31, 1986.
- Deferred income taxes represent timing differences relating to the use of accelerated depreciation methods for income tax reporting and the straight-line method for financial statement reporting.

**Required:**

Using the cash basis approach (funds defined as cash), prepare a statement of changes in financial position of Farrell Corporation for the year ended December 31, 1981.

**D. Statement of Owners’ Equity**

**1N83**

**Number 4 (Estimated time — — 45 to 55 minutes)**

Ashwood, Inc., is a public enterprise whose shares are traded in the over-the-counter market. At December 31, 1981, Ashwood had 6,000,000 authorized shares of $10 par value common stock, of which 2,000,000 shares were issued and outstanding. The stockholders’ equity accounts at December 31, 1981, had the following balances:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>7,500,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>6,500,000</td>
</tr>
</tbody>
</table>
Transactions during 1982 and other information relating to the stockholders’ equity accounts were as follows:

- On January 5, 1982, Ashwood 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. Ashwood had 600,000 authorized shares of preferred stock. The preferred stock has a liquidation value equal to its par value.
- On February 1, 1982, Ashwood reacquired 20,000 shares of its common stock for $16 per share. Ashwood uses the cost method to account for treasury stock.
- On April 30, 1982, Ashwood sold 500,000 shares (previously unissued) of $10 par value common stock to the public at $17 per share.
- On June 18, 1982, Ashwood declares a cash dividend of $1 per share of common stock, payable on July 12, 1982, to stockholders of record on July 1, 1982.
- On November 10, 1982, Ashwood sold 10,000 shares of treasury stock for $21 per share.
- On January 20, 1983, before the books were closed for 1982, Ashwood became aware that the ending inventories at December 31, 1981, were understated by $300,000 (after tax effect on 1981 net income was $180,000). The appropriate correction entry was recorded the same day.
- After correcting the beginning inventory, net income for 1982 was $4,500,000.

Required (show supporting computations in good form):

1. Prepare a statement of retained earnings for the year ended December 31, 1982. Assume that only single-period financial statements for 1982 are presented.

E. Consolidated Financial Statements or Worksheets

1N83
Number 5 (Estimated time — — 40 to 50 minutes)

Amboy Corporation acquired all of the outstanding $10 par voting common stock of Taft, Inc., on January 1, 1982, in exchange for 50,000 shares of its $10 par voting common stock. On December 31, 1981, Amboy's common stock had a closing market price of $15 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, 1982, after year-end adjustments but before the nominal accounts were closed, the companies had condensed general ledger trial balances as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amboy Dr. (Cr.)</th>
<th>Taft Dr. (Cr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$(1,900,000)</td>
<td>$(1,500,000)</td>
</tr>
<tr>
<td>Dividend income from Taft, Inc.</td>
<td>(40,000)</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of warehouse</td>
<td>(30,000)</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,180,000</td>
<td>870,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>550,000</td>
<td>440,000</td>
</tr>
<tr>
<td>(includes depreciation)</td>
<td>550,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>285,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>430,000</td>
<td>350,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>530,000</td>
<td>410,000</td>
</tr>
<tr>
<td>Land, plant &amp; equipment</td>
<td>660,000</td>
<td>680,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(185,000)</td>
<td>(210,000)</td>
</tr>
<tr>
<td>Investment in Taft, Inc. (at cost)</td>
<td>750,000</td>
<td></td>
</tr>
<tr>
<td>Accounts payable &amp; accrued expenses</td>
<td>(670,000)</td>
<td>(594,000)</td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>(1,200,000)</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>(140,000)</td>
<td>(80,000)</td>
</tr>
<tr>
<td>Retained earnings (1/1/82)</td>
<td>(220,000)</td>
<td>(156,000)</td>
</tr>
<tr>
<td>Dividends paid</td>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 0</strong></td>
<td><strong>$ 0</strong></td>
</tr>
</tbody>
</table>
### Amboy Corporation and Subsidiary
#### Consolidated Statement Worksheet
#### December 31, 1982

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Amboy Corp.</th>
<th>Taft Inc.</th>
<th>Adjustments and Eliminations</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales:</td>
<td>$(1,900,000)</td>
<td>$(1,500,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends from Taft</td>
<td>(40,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on sale of warehouse</td>
<td>(30,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,180,000</td>
<td>870,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses (incl. deprec.)</td>
<td>550,000</td>
<td>440,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$ (240,000)</td>
<td>$ (190,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Retained Earnings Statement**

<table>
<thead>
<tr>
<th></th>
<th>Amboy Corp.</th>
<th>Taft Inc.</th>
<th>Adjustments and Eliminations</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 1/1/82</td>
<td>$ (220,000)</td>
<td>$ (156,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>(240,000)</td>
<td>190,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid</td>
<td></td>
<td>40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, 12/31/82</td>
<td>$ (460,000)</td>
<td>$ (306,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Balance Sheet**

<table>
<thead>
<tr>
<th>Assets:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 285,000</td>
<td>$ 150,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>430,000</td>
<td>350,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>530,000</td>
<td>410,000</td>
</tr>
<tr>
<td>Land, plant &amp; equipment</td>
<td>660,000</td>
<td>680,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(185,000)</td>
<td>(210,000)</td>
</tr>
</tbody>
</table>

| Investment in Taft (at cost)                 | 750,000    |            |

| $ 2,470,000                                  | $ 1,380,000|            |

**Liabilities & Stockholders' Equity:**

| Accounts pay. & accrued exp.                 | $ (670,000) | $ (594,000) |
| Common stock ($10 par)                       | (1,200,000) | (400,000)   |
| Additional paid-in capital                   | (140,000)   | (80,000)    |
| Retained Earnings                            | (460,000)   | (306,000)   |

| $ (2,470,000)                                | $ (1,380,000)|            |
Additional information is as follows:

- There were no changes in the common stock and additional paid-in capital accounts during 1982 except the one necessitated by Amboy’s acquisition of Taft.
- At the acquisition date the current value of Taft’s machinery exceeded its book value by $54,000. The excess will be amortized over the estimated average remaining life of six years. The fair values of all of Taft’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, 1982, Amboy sold a warehouse facility to Taft for $129,000 cash. At the date of sale Amboy’s book values were $33,000 for the land and $66,000 for the undepreciated cost of the building. Taft allocated the $129,000 purchase price to the land for $43,000 and to the building for $86,000. Taft is depreciating the building over its estimated five-year remaining useful life by the straight-line method with no salvage value.

- During 1982 Amboy purchased merchandise from Taft at an aggregate invoice price of $180,000, which included a 100% markup on Taft’s cost. At December 31, 1982, Amboy owed Taft $75,000 on these purchases, and $36,000 of the merchandise purchased remained in Amboy’s inventory.

**Required:**

Go to page AP-161 and remove tear-out worksheet. Complete the tear-out worksheet to prepare a consolidated income statement and retained earnings statement for the year ended December 31, 1982, and a consolidated balance sheet as at December 31, 1982, for Amboy Corporation and its subsidiary, Taft, Inc. Formal consolidated statements and journal 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 turn in with other answer sheets.

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

A. Cash, Marketable Securities, and Investments

2N83

**Number 5 (Estimated time — 40 to 50 minutes)**

At December 31, 1982, Winsor Corp. properly reported as current assets the following marketable equity securities:

<table>
<thead>
<tr>
<th>Security</th>
<th>Market Value</th>
<th>Less Valuation Allowance</th>
<th>Marketable Equity Securities at Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bea Corp., 1,000 shares, $2.40 convertible preferred stock</td>
<td>$40,000</td>
<td>7,000</td>
<td>$148,000</td>
</tr>
<tr>
<td>Cha, Inc., 6,000 shares of common stock</td>
<td>60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dey Co., 2,000 shares of common stock</td>
<td>55,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketable equity securities at cost</td>
<td>$155,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

On January 2, 1983, Winsor purchased 100,000 shares of Eddie Corp. common stock for $1,700,000, representing 30% of Eddie’s outstanding common stock and an underlying equity of $1,400,000 in Eddie’s net assets at January 2. Winsor, which had no other financial transactions with Eddie during 1983, amortizes goodwill over a 40-year period. As a result of Winsor’s 30% ownership of Eddie, Winsor has the ability to exercise significant influence over Eddie’s financial and operating policies.

During 1983, Winsor disposed of the following securities:

- January 18 — sold 2,500 shares of Cha for $13 per share.
- June 1 — sold 500 shares of Dey, after a 10% stock dividend, for $21 per share.
- October 1 — converted 500 shares of Bea’s preferred stock into 1,500 shares of Bea’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 1983 dividend information pertains to the stock held by Winsor:

- February 14 — Dey issued a 10% stock dividend, when the market price of Dey’s common stock was $22 per share.
- April 5 and October 5 — Bea paid dividends of $1.20 per share on its $2.40 preferred stock, to stockholders of record on March 9 and September 9, respectively. Bea did not pay any dividends on its common stock during 1983.
- June 30 — Cha paid a $1.00 per share dividend on its common stock.
- March 1, June 1, September 1, and December 1 — Eddie paid quarterly dividends of $0.50 per share on each of these dates. Eddie’s net income for the year ended December 31, 1983, was $1,200,000.

At December 31, 1983, Winsor’s management intended to hold the Eddie 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:
Selected Questions

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1982</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bea Corp. — preferred</td>
<td>$56</td>
<td>$42</td>
</tr>
<tr>
<td>Bea Corp. — common</td>
<td>20</td>
<td>18</td>
</tr>
<tr>
<td>Cha, Inc. — common</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>Dey Co. — common</td>
<td>22</td>
<td>20</td>
</tr>
<tr>
<td>Eddie Corp. — common</td>
<td>16</td>
<td>18</td>
</tr>
</tbody>
</table>

All of the foregoing stocks are listed on major stock exchanges. Declines in market value from cost would not be considered as permanent declines.

Required:

a. Prepare a schedule of Winsor’s current marketable equity securities at December 31, 1983, including any information necessary to determine the related valuation allowance and unrealized gross gains and losses.

b. Prepare a schedule to show the carrying amount of Winsor’s noncurrent marketable equity securities at December 31, 1983.

c. Prepare a schedule showing all income, gains, and losses (realized and unrealized) relating to Winsor’s investments, for the year ended December 31, 1983.

1M81
Number 4 (Estimated time — 45 to 55 minutes)

Number 4 consists of two unrelated parts.

Part a. On June 1, 1979, Warner, Inc., purchased as a long-term investment $800 of the $1,000 face value, 8% bonds of Universal Corporation for $738,300. The bonds were purchased to yield 10% interest. Interest is payable semiannually on December 1 and June 1. The bonds mature on June 1, 1984. Warner uses the effective interest method of amortization. On November 1, 1980, Warner sold the bonds for $785,000. This amount includes the appropriate accrued interest.

Required:

Prepare a schedule showing the income or loss before income taxes from the bond investment that Warner should record for the years ended December 31, 1979, and 1980. Show supporting computations in good form.

Part b. On January 1, 1979, Jeffries, Inc., paid $700,000 for 10,000 shares of Wolf Company’s voting common stock which represents a 30% investment in Wolf. The fair values of all of Wolf’s identifiable assets net of liabilities were equal to their book values of $6,500,000. As a result of this transaction, Jeffries has the ability to exercise significant influence over the operating and financial policies of Wolf. Jeffries received dividends of $1.10 per share from Wolf on April 1, 1980, and $1.35 per share on October 1, 1980. Wolf reported net income of $500,000 for the year ended December 31, 1980, and $200,000 for the six months ended December 31, 1980. Jeffries amortizes goodwill over a forty-year period.

Required:

1. Prepare a schedule showing the income or loss before income taxes for the year ended December 31, 1979, that Jeffries should report from its investment in Wolf in its income statement issued in March 1980.

2. During March 1981 Jeffries issues comparative financial statements for 1979 and 1980. Prepare schedules showing the income or loss before income taxes for the years ended December 31, 1979, and 1980, that Jeffries should report from its investment in Wolf. Show supporting computations in good form.

B. Receivables and Accruals

1M84
Number 5 (Estimated time — 40 to 50 minutes)

Linden, Inc., had the following long-term receivable account balances at December 31, 1982:

Note receivable from sale of division $1,500,000
Note receivable from officer 400,000

Transactions during 1983 and other information relating to Linden’s long-term receivables were as follows:

- The $1,500,000 note receivable is dated May 1, 1982, bears interest at 9%, and represents the balance of the consideration received from the sale of Linden’s electronics division to Pitt Company. Principal payments of $500,000 plus appropriate interest are due on May 1, 1983, 1984, and 1985. The first principal and interest payment was made on May 1, 1983. Collection of the note installments is reasonably assured.

- The $400,000 note receivable is dated December 31, 1980, bears interest at 8%, and is due on December 31, 1985. The note is due from Robert Finley, president of Linden, Inc., and is collateralized by 10,000 shares of Linden’s common stock. Interest is payable annually on December 31 and all interest payments were made on their due dates through December 31, 1983. The quoted market price of Linden’s common stock was $45 per share on December 31, 1983.

- On April 1, 1983, Linden sold a patent to Bell Company in exchange for a $100,000 noninterest bear-
classifying note due on April 1, 1985. 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 April 1, 1983, was 15%. The present value of $1 for two periods at 15% is 0.756. The patent had a carrying value of $40,000 at January 1, 1983, and the amortization for the year ended December 31, 1983, would have been $8,000. The collection of the note receivable from Bell is reasonably assured.

- On July 1, 1983, Linden sold a parcel of land to Carr Company for $200,000 under an installment sale contract. Carr made a $60,000 cash down payment on July 1, 1983, and signed a four-year 16% note for the $140,000 balance. The equal annual payments of principal and interest on the note will be $50,000 payable on July 1, 1984, through July 1, 1987. The land could have been sold at an established cash price of $200,000. The cost of the land to Linden was $150,000. Circumstances are such that the collection of the installments on the note is reasonably assured.

**Required:**

1. Prepare the long-term receivables section of Linden's balance sheet at December 31, 1983.
2. Prepare a schedule showing the current portion of the long-term receivables and accrued interest receivable that would appear in Linden's balance sheet at December 31, 1983.
3. Prepare a schedule showing interest income from the long-term receivables and gains recognized on sale of assets that would appear on Linden's income statement for the year ended December 31, 1983.

**Classification by month of sale**

<table>
<thead>
<tr>
<th>Month of Sale</th>
<th>Balance in each category</th>
<th>Estimated % uncollectible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nov-Dec 1982</td>
<td>$1,140,000</td>
<td>2%</td>
</tr>
<tr>
<td>Jul-Oct</td>
<td>600,000</td>
<td>10</td>
</tr>
<tr>
<td>Jan-June</td>
<td>400,000</td>
<td>25</td>
</tr>
<tr>
<td>Prior to 1/1/82</td>
<td>130,000</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>$2,270,000</td>
<td></td>
</tr>
</tbody>
</table>

Based on the review of collectibility of the account balances in the "prior to 1/1/82" aging category, additional receivables totaling $60,000 were written off as of December 31, 1982. Effective with the year ended December 31, 1982, Harris adopted a new accounting method for estimating the allowance for doubtful accounts at the amount indicated by the year-end aging analysis of accounts receivable.

**Required:**

1. Prepare a schedule analyzing the changes in the allowance for doubtful accounts for the year ended December 31, 1982. Show supporting computations in good form.
2. Prepare the journal entry for the year-end adjustment to the allowance for doubtful accounts balance as of December 31, 1982.

**C. Inventories**

**1M83**

**Number 4**

Number 4 consists of two unrelated parts.

**Part a.** From inception of operations to December 31, 1981, Harris Corporation provided for uncollectible accounts receivable under the allowance method: provisions were made monthly at 2% of credit sales; bad debts written off were charged to the allowance account; recoveries of bad debts previously written off were credited to the allowance account; and, no year-end adjustments to the allowance account were made. Harris's usual credit terms are net 30 days.

The balance in the allowance for doubtful accounts was $130,000 at January 1, 1982. During 1982 credit sales totaled $9,000,000, interim provisions for doubtful accounts were made at 2% of credit sales, $90,000 of bad debts were written off, and recoveries of accounts previously written off amounted to $15,000. Harris installed a computer facility in November 1982 and an aging of accounts receivable was prepared for the first time as of December 31, 1982. A summary of the aging is as follows:

<table>
<thead>
<tr>
<th>FIFO basis per records</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units</td>
</tr>
<tr>
<td>Inventories, 1/1/81</td>
</tr>
<tr>
<td>Product A</td>
</tr>
<tr>
<td>Product B</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

AP-164
Selected Questions

The following transactions for the Class F inventory pool took place during 1980:

- On January 10, 1980, 7,500 units were purchased at a unit cost of $14.50 for $108,750.
- On May 15, 1980, 5,500 units were purchased at a unit cost of $15.50 for $85,250.
- On December 29, 1980, 7,000 units were purchased at a unit cost of $16.00 for $112,000.
- A total of 16,000 units were used for production during 1980.

Required:
1. Prepare a schedule to compute the inventory (units and dollar amounts) of the Class F inventory pool at December 31, 1979. Show supporting computations in good form.
2. Prepare a schedule to compute the cost of Class F raw materials used in production for the year ended December 31, 1979.
3. Prepare a schedule to compute the inventory (units and dollar amounts) of the Class F inventory pool at December 31, 1980. Show supporting computations in good form.

Part b. Layne Corporation, a manufacturer of small tools, provided the following information from its accounting records for the year ended December 31, 1980:

Inventory at December 31, 1980 (based on physical count of goods in Layne's plant at cost on December 31, 1980) $1,750,000
Accounts payable at December 31, 1980 1,200,000
Net sales (sales less sales returns) 8,500,000

Additional information is as follows:

1. Included in the physical count were tools billed to a customer F.O.B. shipping point on December 31, 1980. These tools had a cost of $28,000 and were billed at $35,000. The shipment was on Layne's loading dock waiting to be picked up by the common carrier.
2. Goods were in transit from a vendor to Layne on December 31, 1980. The invoice cost was $50,000, and the goods were shipped F.O.B. shipping point on December 29, 1980.
3. Work-in-process inventory costing $20,000 was sent to an outside processor for plating on December 30, 1980.
4. Tools returned by customers and held pending inspection in the returned goods area on December 31, 1980, were not included in the physical count. On January 8, 1981, the tools costing $26,000 were inspected and returned to inventory. Credit memos totaling $40,000 were issued to the customers on the same date.
5. Tools shipped to a customer F.O.B. destination on December 26, 1980, were in transit at December 31, 1980, and had a cost of $25,000. Upon notification of receipt by the customer on January 2, 1981, Layne issued a sales invoice for $42,000.
6. Goods, with an invoice cost of $30,000, received from a vendor at 5:00 P.M. on December 31, 1980, were recorded on a receiving report dated January 2, 1981. The goods were not included in the physical count, but the invoice was included in accounts payable at December 31, 1980.

7. Goods received from a vendor on December 26, 1980, were included in the physical count. However, the related $60,000 vendor invoice was not included in accounts payable at December 31, 1980, because the accounts payable copy of the receiving report was lost.

8. On January 3, 1981, a monthly freight bill in the amount of $4,000 was received. The bill specifically related to merchandise purchased in December 1980, one-half of which was still in the inventory at December 31, 1980. The freight charges were not included in either the inventory or in accounts payable at December 31, 1980.

Required:

Using the format shown below, prepare a schedule of adjustments as of December 31, 1980, to the initial amounts per Layne’s accounting records. Show separately the effect, if any, of each of the eight transactions on the December 31, 1980, amounts. If the transactions would have no effect on the initial amount shown, state NONE.

<table>
<thead>
<tr>
<th>Adjustments</th>
<th>Inventory</th>
<th>Accounts payable</th>
<th>Net sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>increase</td>
<td>$1,750,000</td>
<td>$1,200,000</td>
<td>$8,500,000</td>
</tr>
<tr>
<td>decrease</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Adjusted amounts</th>
<th>$</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
</table>

Account balances at January 1, 1984

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$150,000</td>
</tr>
<tr>
<td>Building</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$263,100</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>900,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>250,000</td>
</tr>
<tr>
<td>Automotive equipment</td>
<td>115,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>84,600</td>
</tr>
</tbody>
</table>

Depreciation method and useful life

Building — 150% declining balance; 25 years.
Machinery and equipment — Straight-line; ten years.
Automotive equipment — Sum-of-the-years-digits; four years.
Leasehold improvements — Straight-line.
The salvage value of the depreciable assets is immaterial.
Depreciation is computed to the nearest month.

Transactions during 1984 and other information

On January 2, 1984, Blake purchased a new car for $10,000 cash and trade-in of a two-year-old car with a cost of $9,000 and a book value of $2,700. The new car has a cash price of $12,000; the market value of the trade-in is not known.

On April 1, 1984, a machine purchased for $23,000 on April 1, 1979, was destroyed by fire. Blake recovered $15,500 from its insurance company.

On May 1, 1984, costs of $168,000 were incurred to improve leased office premises. The leasehold improvements have a useful life of eight years. The related lease, which terminates on December 31, 1990, is renewable for an additional six-year term. The decision to renew will be made in 1990 based on office space needs at that time.

On July 1, 1984, machinery and equipment were purchased at a total invoice cost of $280,000; additional costs of $5,000 for freight and $25,000 for installation were incurred.

Blake determined that the automotive equipment comprising the $115,000 balance at January 1, 1984, would have been depreciated at a total amount of $18,000 for the year ended December 31, 1984.

Required:

a. For each asset classification prepare schedules showing depreciation and amortization expense, and accumulated depreciation and amortization that would appear on Blake’s income statement for the year ended December 31, 1984, and balance sheet at December 31, 1984, respectively.

b. Prepare a schedule showing gain or loss from disposal of assets that would appear in Blake’s income statement for the year ended December 31, 1984.

c. Prepare the property, plant and equipment section of Blake’s December 31, 1984, balance sheet.

D. Property, Plant, and Equipment Owned or Leased

1M85

Number 4 (Estimated time — 45 to 55 minutes)

Information pertaining to Blake Corporation’s property, plant and equipment for 1984 is presented below.
Number 5 consists of two unrelated parts.

Part b. On January 1, 1980, Brock Corporation purchased a tract of land (site number 101) with a building for $600,000. Additionally, Brock paid a real estate broker's commission of $36,000, legal fees of $6,000, and title guarantee insurance of $18,000. The closing statement indicated that the land value was $500,000 and the building value was $100,000. Shortly after acquisition, the building was razed at a cost of $75,000.

Brock entered into a $3,000,000 fixed-price contract with Barnett Builders, Inc., on March 1, 1980, for the construction of an office building on land site number 101. The building was completed and occupied on September 30, 1981. Additional construction costs were incurred as follows:

- Plans, specifications, and blueprints: $12,000
- Architects' fees for design and supervision: $95,000

The building is estimated to have a forty-year life from date of completion and will be depreciated using the 150% declining balance method.

To finance the construction cost, Brock borrowed $3,000,000 on March 1, 1980. The loan is payable in ten annual installments of $300,000 plus interest at the rate of 14 percent. Brock's average amounts of accumulated building construction expenditures were as follows:

- For the period March 1 to December 31, 1980: $900,000
- For the period January 1 to September 30, 1981: $2,300,000

Required:
1. Prepare a schedule which discloses the individual costs making up the balance in the land account in respect of land site number 101 as of September 30, 1981.
2. Prepare a schedule which discloses the individual costs that should be capitalized in the office building account as of September 30, 1981. Show supporting computations in good form.
3. Prepare a schedule showing the depreciation expense computation of the office building for the year ended December 31, 1981.

Selected Questions

Number 5 consists of two unrelated parts.

Part b. Dumont Corporation, a lessor of office machines, purchased a new machine for $500,000 on December 31, 1979, which was delivered the same day (by prior arrangement) to Finley Company, the lessee. The following information relating to the lease transaction is available:

- The leased asset has an estimated useful life of seven years which coincides with the lease term.
- At the end of the lease term, the machine will revert to Dumont, at which time it is expected to have a residual value of $60,000 (none of which is guaranteed by Finley).
- The 10% investment tax credit on the asset cost is retained by Dumont and is expected to be realized in its 1979 income tax return.
- Dumont's implicit interest rate (on its net investment) is 12%, which is known by Finley.
- Finley's incremental borrowing rate is 14% at December 31, 1979.
- Lease rentals consist of seven equal annual payments, the first of which was paid on December 31, 1979.
- The lease is appropriately accounted for as a direct financing lease by Dumont and as a capital lease by Finley. Both lessor and lessee are calendar-year corporations and depreciate all fixed assets on the straight-line basis.

Information on present value factors is as follows:

- Present value of $1 for seven periods at 12%: 0.452
- Present value of $1 for seven periods at 14%: 0.400
- Present value of an annuity of $1 in advance for seven periods at 12%: 5.111
- Present value of an annuity of $1 in advance for seven periods at 14%: 4.889

Required (round all amounts to the nearest dollar):
1. Compute the annual rental under the lease. Show all computations in good form.
2. Compute the amounts of the gross lease rentals receivable and the unearned interest revenue that Dumont should disclose at the inception of the lease on December 31, 1979. Show all computations in good form.
3. What expense should Finley record for the year ended December 31, 1980? Show supporting computations in good form.
E. Intangibles and Other Assets

1N82
Number 5

Number 5 consists of two unrelated parts.

Part a. Information concerning Tully Corporation's intangible assets is as follows:

- On January 1, 1981, Tully signed an agreement to operate as a franchisee of Rapid Copy Service, Inc., for an initial franchise fee of $85,000. Of this amount, $25,000 was paid when the agreement was signed and the balance is payable in four annual payments of $15,000 each beginning January 1, 1982. The agreement provides that the down payment is not refundable and no future services are required of the franchisor. The present value at January 1, 1981, of the four annual payments discounted at 14% (the implicit rate for a loan of this type) is $43,700. The agreement also provides that 5% of the revenue from the franchise must be paid to the franchisor annually. Tully's revenue from the franchise for 1981 was $900,000. Tully estimates the useful life of the franchise to be ten years.
- Tully incurred $78,000 of experimental and development costs in its laboratory to develop a patent which was granted on January 2, 1981. Legal fees and other costs associated with registration of the patent totaled $16,400. Tully estimates that the useful life of the patent will be eight years.
- A trademark was purchased from Walton Company for $40,000 on July 1, 1978. Expenditures for successful litigation in defense of the trademark totaling $10,000 were paid on July 1, 1981. Tully estimates that the useful life of the trademark will be 20 years from the date of acquisition.

Required:

1. Prepare a schedule showing the intangibles section of Tully's balance sheet at December 31, 1981. Show supporting computations in good form.
2. Prepare a schedule showing all expenses resulting from the transactions that would appear on Tully's income statement for the year ended December 31, 1981. Show supporting computations in good form.

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

1N84
Number 4 (Estimated time — — 45 to 55 minutes)

Included in Bristol Corporation's liability account balances at December 31, 1982 were the following:

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable, bank</td>
<td>$2,800,000</td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>430,000</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>360,000</td>
</tr>
</tbody>
</table>

Transactions during 1983 and other information relating to Bristol's liabilities were as follows:

- The principal amount of the note payable is $2,800,000 and bears interest at 15%. The note is dated April 1, 1982, and is payable in four equal annual installments of $700,000 beginning April 1, 1983. The first principal and interest payment was made on April 1, 1983.
- The capitalized lease is for a ten-year period beginning December 31, 1980. Equal annual payments of $100,000 are due on December 31 of each year, and the 14% interest rate implicit in the lease is known by Bristol. The present value at December 31, 1982, of the seven remaining lease payments (due December 31, 1983, through December 31, 1989) discounted at 14% was $430,000.
- 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, 1983, depreciation per tax return exceeded book depreciation by $90,000. Bristol's effective income tax rate for 1983 was 40%.
- On July 1, 1983, Bristol issued for $1,774,000, $2,000,000 face amount of its 10%, $1,000 bonds. The bonds were issued to yield 12%. The bonds are dated July 1, 1983, and mature on July 1, 1993. Interest is payable annually on July 1. Bristol uses the interest method to amortize bond discount.

Required:

a. Prepare the long-term liabilities section of Bristol's balance sheet at December 31, 1983.
b. Prepare a schedule showing the current portion of the long-term liabilities and accrued interest payable that would appear in Bristol's balance sheet at December 31, 1983.
c. Prepare a schedule showing interest expense from the long-term liabilities and deferred income tax expense that would appear in Bristol's income statement for the year ended December 31, 1983.

1N82
Number 4

Number 4 consists of two unrelated parts.

and must determine the proper accounting treatment for each of the following situations:

1. Greenlaw sells subscriptions to several magazines for a one-year, two-year, or three-year period. Cash receipts from subscribers are credited to magazine subscriptions collected in advance, and this account had a balance of $2,400,000 at December 31, 1981. Outstanding subscriptions at December 31, 1981, expire as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>During 1982</td>
<td>$600,000</td>
</tr>
<tr>
<td>During 1983</td>
<td>900,000</td>
</tr>
<tr>
<td>During 1984</td>
<td>400,000</td>
</tr>
</tbody>
</table>

2. On January 2, 1981, Greenlaw discontinued collision, fire, and theft coverage on its delivery vehicles and became self-insured for these risks. Actual losses of $45,000 during 1981 were charged to delivery expense. The 1980 premium for the discontinued coverage amounted to $100,000, and the controller wants to set up a reserve for self-insurance by a debit to delivery expense of $55,000 and a credit to the reserve for self-insurance of $55,000.

3. A suit for breach of contract seeking damages of $1,000,000 was filed by an author against Greenlaw on July 1, 1981. The company's legal counsel believes that an unfavorable outcome is probable. A reasonable estimate of the court's award to the plaintiff is in the range between $100,000 and $500,000. No amount within this range is a better estimate of potential damages than any other amount.

4. During December 1981 a competitor company filed suit against Greenlaw for industrial espionage claiming $2,000,000 in damages. In the opinion of management and company counsel, it is reasonably possible that damages will be awarded to the plaintiff. However, the amount of potential damages awarded to the plaintiff cannot be reasonably estimated.

Required:
For each of the situations above, prepare the journal entry that should be recorded as of December 31, 1981, or explain why an entry should not be recorded. Show supporting computations in good form.

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

<table>
<thead>
<tr>
<th>A. Preferred and Common Stock</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2M84</td>
<td></td>
</tr>
<tr>
<td>Number 4 consists of two unrelated parts.</td>
<td></td>
</tr>
<tr>
<td>Part b. Chee Corporation's post-closing trial balance at December 31, 1983, was as follows:</td>
<td></td>
</tr>
</tbody>
</table>

**Chee Corporation**

**POST-CLOSING TRIAL BALANCE**  
**December 31, 1983**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$550,000</td>
<td>$290,000</td>
</tr>
<tr>
<td>Accumulated depreciation —</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>building and equipment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital —</td>
<td></td>
<td></td>
</tr>
<tr>
<td>common</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In excess of par value</td>
<td>1,560,000</td>
<td></td>
</tr>
<tr>
<td>From sale of treasury stock</td>
<td>250,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Allowance to reduce long-term</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>equity securities to market</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Bonds payable</td>
<td>1,100,000</td>
<td></td>
</tr>
<tr>
<td>Building and equipment</td>
<td>220,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Common stock ($1 par value)</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Dividends payable on preferred stock — cash</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4,000</td>
<td></td>
</tr>
</tbody>
</table>

| Total                           | $3,640,000 | $3,640,000 |

At December 31, 1983, Chee had the following number of common and preferred shares:

<table>
<thead>
<tr>
<th></th>
<th>Common</th>
<th>Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized</td>
<td>500,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Issued</td>
<td>150,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Outstanding</td>
<td>140,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

The dividends on preferred stock are $4 cumulative. In addition, the preferred stock has a preference in liquidation of $50 per share.

Required:
Prepare the stockholders' equity section of Chee's balance sheet at December 31, 1983.
E. Stock Options, Warrants, and Rights

1N81 Number 5

Number 5 consists of two unrelated parts.

Part a. On January 1, 1978, Holt, Inc., granted stock options to officers and key employees for the purchase of 20,000 shares of the company's $10 par common stock at $25 per share. The options were exercisable within a four-year period beginning January 1, 1980, by grantees still in the employ of the company, and expiring December 31, 1983. The market price of Holt's common stock was $33 per share at the date of grant. Holt prepares a formal journal entry to record this award.

On April 1, 1979, 2,000 option shares were terminated when the employees resigned from the company. The market value of the common stock was $35 per share on this date.

On March 31, 1980, 12,000 option shares were exercised when the market value of the common stock was $40 per share.

Required:
Prepare journal entries to record issuance of the stock options, termination of the stock options, exercise of the stock options, and charges to compensation expense for the years ended December 31, 1978, 1979, and 1980. Show supporting computations in good form.

G. Partnerships

1M82 Number 4

Number 4 consists of two unrelated parts.

Part a. On January 1, 1982, the partners of Allen, Brown, and Cox, who share profits and losses in the ratio of 5:3:2, respectively, decide to liquidate their partnership. The partnership trial balance at this date is as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 18,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>66,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>52,000</td>
</tr>
<tr>
<td>Machinery and equipment, net</td>
<td>189,000</td>
</tr>
<tr>
<td>Allen, loan</td>
<td>30,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$ 53,000</td>
</tr>
<tr>
<td>Brown, loan</td>
<td>20,000</td>
</tr>
<tr>
<td>Allen, capital</td>
<td>118,000</td>
</tr>
<tr>
<td>Brown, capital</td>
<td>90,000</td>
</tr>
<tr>
<td>Cox, capital</td>
<td>74,000</td>
</tr>
<tr>
<td></td>
<td>$355,000</td>
</tr>
</tbody>
</table>

The partners plan a program of piecemeal conversion of assets in order to minimize liquidation losses. All available cash, less an amount retained to provide for future expenses, is to be distributed to the partners at the end of each month. A summary of the liquidation transactions is as follows:

January 1982:

a. $51,000 was collected on accounts receivable; the balance is uncollectible.
b. $38,000 was received for the entire inventory.
c. $2,000 liquidation expenses were paid.
d. $50,000 was paid to outside creditors, after offset of a $3,000 credit memorandum received on January 11, 1982.
e. $10,000 cash was retained in the business at the end of the month for potential unrecorded liabilities and anticipated expenses.

February 1982:

f. $4,000 liquidation expenses were paid.
g. $6,000 cash was retained in the business at the end of the month for potential unrecorded liabilities and anticipated expenses.

March 1982:

h. $146,000 was received on sale of all items of machinery and equipment.
i. $5,000 liquidation expenses were paid.
j. No cash was retained in the business.

Required:
Prepare a schedule to compute safe installment payments to the partners as of January 31, 1982. Show supporting computations in good form.

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

1M82 Number 5

Number 5 consists of two unrelated parts.

Part a. After a two-year search for a buyer, Hobson, Inc., sold its idle plant facility to Jackson Company for $700,000 on January 1, 1977. On this date the plant had a depreciated cost on Hobson's books of $500,000. Under the agreement Jackson paid $100,000 cash on January 1, 1977, and signed a $600,000 note bearing interest at 10%. The note was payable in installments of $100,000, $200,000, and $300,000 on January 1, 1978, 1979, and 1980, respectively. The note was secured by
Selected Questions

Number 5
Part a. (cont.)

a mortgage on the property sold. Hobson appropriately accounted for the sale under the cost recovery method since there was no reasonable basis for estimating the degree of collectibility of the note receivable. Jackson repaid the note with three late installment payments, which were accepted by Hobson, as follows:

<table>
<thead>
<tr>
<th>Date of payment</th>
<th>Principal</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1, 1978</td>
<td>$100,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>December 31, 1979</td>
<td>200,000</td>
<td>75,000</td>
</tr>
<tr>
<td>February 1, 1981</td>
<td>300,000</td>
<td>32,500</td>
</tr>
</tbody>
</table>

On April 1, 1981, Hobson exchanged a tract of land, which it had acquired for $105,000 as a potential future building site, for a used printing press of Tyler Company, and paid a cash difference of $30,000. The fair value of the land was $190,000 on the exchange date based on a recent appraisal. The fair value of the printing press was not reasonably determinable, but it had a depreciated cost of $210,000 on Tyler’s books at April 1, 1981.

Required:
1. Prepare a schedule (using the format shown below) to record the initial transaction for the sale of the idle plant facility, the application of subsequent cash collections on the note, and the necessary journal entry on the date the transaction is complete.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash received</th>
<th>Note receivable</th>
<th>Idle plant (net)</th>
<th>Deferred income</th>
<th>Income recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debit</td>
<td>Dr. (Cr.)</td>
<td>(Credit)</td>
<td>Dr. (Cr.)</td>
<td>(Credit)</td>
</tr>
<tr>
<td>January 1, 1977</td>
<td>$100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>July 1, 1978</td>
<td>190,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 31, 1979</td>
<td>275,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>February 1, 1981</td>
<td>332,500</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Prepare the journal entry on Hobson’s books to record the exchange transaction with Tyler. Show supporting computations in good form.

B. Expenses and Losses

1M82
Number 5

Number 5 consists of two unrelated parts.

Part b. Foster Corporation, a calendar-year company, adopted a noncontributory defined benefit pension plan on January 1, 1980. Foster’s actuarial consulting firm recommended a 6% interest rate as appropriate and, applying an acceptable actuarial method, determined that the past service cost at the date of adoption of the plan is $300,000. Management decided to amortize the past service cost over 16 years and to fund the past service cost by making equal payments to the pension fund trustee at the end of each of the first 20 years. As of December 31, 1981, no benefits have vested. The normal (current) pension cost is to be funded fully each year. Information provided by the actuarial consultant relating to the pension plan for the years 1980 and 1981 is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortization of past service cost</th>
<th>Funding of past service cost</th>
<th>Normal pension cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>$29,685</td>
<td>26,155</td>
<td>60,000</td>
</tr>
<tr>
<td>1981</td>
<td>$29,685</td>
<td>26,155</td>
<td>65,000</td>
</tr>
</tbody>
</table>

Required:
1. Prepare schedules to compute the amounts relating to the pension plan that Foster should report on its income statement and balance sheet for 1980 and 1981. Show supporting computations in good form.
2. Compute the minimum and maximum pension cost limits allowable under generally accepted accounting principles for 1980. Show supporting computations in good form.

1M81
Number 5

Number 5 consists of two unrelated parts.

Part a. On February 20, 1980, Riley, Inc., purchased a machine for $1,200,000 for the purpose of leasing it. The machine is expected to have a ten-year life, no residual value, and will be depreciated on the straight-line basis. The machine was leased to Sutter Company on March 1, 1980, for a four-year period at a monthly rental of $18,000. There is no provision for the renewal of the lease or purchase of the machine by the lessee at the expiration of the lease term. Riley paid $60,000 of commissions associated with negotiating the lease in February 1980.

Required:
1. What expense should Sutter record as a result of the above facts for the year ended December 31, 1980? Show supporting computations in good form.
2. What income or loss before income taxes should Riley record as a result of the above facts for
Accounting Practice

the year ended December 31, 1980? Show supporting computations in good form.

C. Provision for Income Tax

2N82
Number 4 (Estimated time — 45 to 55 minutes)

In January 1982, you began the examination of the financial statements for the year ended December 31, 1981, of Howe Corporation, a new audit client. During your examination the following information was disclosed:

- On January 2, 1979, packaging equipment was purchased at a cost of $450,000. The equipment had an estimated useful life of five years and a salvage value of $60,000. Howe was entitled to and claimed an investment credit of $30,000 on its 1979 income tax return. For financial reporting purposes, the investment credit was treated as an offset against the cost of the equipment. The sum-of-the-years' digits method of depreciation was used for income tax reporting and the straight-line method was used on the financial statements.
- On January 3, 1980, $120,000 was collected in advance rental of a building for a three-year period. The $120,000 was reported as taxable income in 1980, but $80,000 was reported as deferred revenue in 1980 in the financial statements. The building will continue to be rented for the foreseeable future.
- On February 9, 1981, Howe sold land with a book and tax basis of $300,000 for $400,000. The gain, reported in full in 1981 on the financial statements, was reported by the installment method on the income tax return equally over a period of ten years and is taxable at the capital gains rate.
- On March 10, 1981, a patent was purchased at a cost of $68,000. Howe is amortizing the patent over a period of four years on the financial statements and over 17 years on its income tax return. Howe elected to record a full year's amortization in 1981 on both its financial statements and income tax return.

Based on effective income tax rates of 40% on ordinary income and 28% on long-term capital gains, the following federal income tax liabilities were reported on Howe's income tax returns:

<table>
<thead>
<tr>
<th></th>
<th>1979</th>
<th>1980</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 50,000</td>
<td>142,400</td>
<td>101,280</td>
</tr>
</tbody>
</table>

Required:
- Prepare schedules computing
  1. Net deductions for tax reporting purposes, giving rise to interperiod tax allocation on ordinary income for each year ended December 31, 1979, 1980, and 1981.
  2. Net deductions for financial statements adjusted for applicable permanent differences, giving rise to interperiod tax allocation on ordinary income for each year ended December 31, 1979, 1980, and 1981.
  3. Deferred tax credit at the capital gains rate at December 31, 1981.

F. Earnings Per Share

1N81
Number 5

Number 5 consists of two unrelated parts.

Part b. Mason Corporation's capital structure is as follows:

<table>
<thead>
<tr>
<th>December 31</th>
<th>1980</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding shares:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>336,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Nonconvertible preferred stock</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>8% convertible bonds</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

The following additional information is available:

- On September 1, 1980, Mason sold 36,000 additional shares of common stock.
- Net income for the year ended December 31, 1980, was $750,000.
- During 1980 Mason paid dividends of $3.00 per share on its nonconvertible preferred stock.
- The 8% convertible bonds are convertible into 40 shares of common stock for each $1,000 bond, and were not considered common stock equivalents at the date of issuance.
- Unexercised stock options to purchase 30,000 shares of common stock at $22.50 per share were outstanding at the beginning and end of 1980. The average market price of Mason's common stock was $36 per share during 1980. The market price was $33 per share at December 31, 1980.
- Warrants to purchase 20,000 shares of common stock at $38 per share were attached to the preferred stock at the time of issuance. The warrants, which expire on December 31, 1985, were outstanding at December 31, 1980.
- Mason's effective income tax rate was 40% for 1979 and 1980.

Required (show supporting computations in good form and round earnings per share to the nearest penny):

1. Compute the number of shares which should be used for the computation of primary earnings per common share for the year ended December 31, 1980.
2. Compute the primary earnings per common share for the year ended December 31, 1980.
3. Compute the number of shares which should be used for the computation of fully diluted earnings per common share for the year ended December 31, 1980.
4. Compute the fully diluted earnings per common share for the year ended December 31, 1980.

VII. Cost Accumulation, Planning, and Control

2M85
Number 4 (Estimated time — 45 to 55 minutes)

Mayne Manufacturing Co. has incurred substantial losses for several years, and has become insolvent. On March 31, 1985, Mayne petitioned the court for protection from creditors, and submitted the following statement of financial position:

Mayne Manufacturing Co.
STATEMENT OF FINANCIAL POSITION
March 31, 1985

<table>
<thead>
<tr>
<th>Book value</th>
<th>Liquidation value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$100,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>150,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$340,000</td>
</tr>
<tr>
<td><strong>Liabilities and Stockholders' Equity:</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts payable — general creditors</td>
<td>$600,000</td>
</tr>
<tr>
<td>Common stock outstanding</td>
<td>60,000</td>
</tr>
<tr>
<td>Deficit (320,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$340,000</td>
</tr>
</tbody>
</table>

Mayne's management informed the court that the company has developed a new product, and that a prospective customer is willing to sign a contract for the purchase of 10,000 units of this product during the year ending March 31, 1986, 12,000 units of this product during the year ending March 31, 1987, and 15,000 units of this product during the year ending March 31, 1988, at a price of $90 per unit. This product can be manufactured using Mayne's present facilities. Monthly production with immediate delivery is expected to be uniform within each year. Receivables are expected to be collected during the calendar month following sales.

Unit production costs of the new product are expected to be as follows:

| Direct materials | $20 |
| Direct labor | 30 |
| Variable overhead | 10 |

Fixed costs (excluding depreciation) will amount to $130,000 per year.
Purchases of direct materials will be paid during the calendar month following purchase. Fixed costs, direct labor, and variable overhead will be paid as incurred. Inventory of direct materials will be equal to 60 days' usage. After the first month of operations, 30 days' usage of direct materials will be ordered each month.
The general creditors have agreed to reduce their total claims to 60% of their March 31, 1985 balances, under the following conditions:

- Existing accounts receivable and inventories are to be liquidated immediately, with the proceeds turned over to the general creditors.
- The balance of reduced accounts payable is to be paid as cash is generated from future operations, but in no event later than March 31, 1987. No interest will be paid on these obligations.

AP-173
Under this proposed plan, the general creditors would receive $110,000 more than the current liquidation value of Mayne’s assets. The court has engaged you to determine the feasibility of this plan.

**Required:**

Ignoring any need to borrow and repay short-term funds for working capital purposes, prepare a cash budget for the years ending March 31, 1986 and 1987, showing the cash expected to be available to pay the claims of the general creditors, payments to general creditors, and the cash remaining after payment of claims.

2N84

**Number 5 (Estimated time — — 40 to 50 minutes)**

Poe Corp. has manufacturing plants in Boston and Chicago. Both plants produce the same product, Xoff, which sells for $20 per unit. Budgeted revenues and costs for the year ending December 31, 1985, are:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$6,200</td>
<td>$2,200</td>
<td>$4,000</td>
</tr>
<tr>
<td>Variable factory costs:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>1,550</td>
<td>550</td>
<td>1,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,660</td>
<td>660</td>
<td>1,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>1,140</td>
<td>440</td>
<td>700</td>
</tr>
<tr>
<td>Fixed factory overhead costs</td>
<td>1,600</td>
<td>700</td>
<td>900</td>
</tr>
<tr>
<td>Fixed regional promotional costs</td>
<td>200</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Allocated home office costs</td>
<td>310</td>
<td>110</td>
<td>200</td>
</tr>
<tr>
<td>Total costs</td>
<td>6,460</td>
<td>2,560</td>
<td>3,900</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>$( 260)</td>
<td>$( 360)</td>
<td>$ 100</td>
</tr>
</tbody>
</table>

Home office costs are fixed, and are allocated to manufacturing plants on the basis of relative sales levels. Fixed regional promotional costs are discretionary advertising costs needed to obtain budgeted sales levels. Because of the budgeted operating loss, Poe is considering the possibility of ceasing operations at its Boston plant. If Poe were to cease operations at its Boston plant, proceeds from the sale of plant assets would exceed their book value and exactly cover all termination costs; fixed factory overhead costs of $50,000 would not be eliminated. Poe is considering the following three alternative plans:

- **Plan A** — Expand Boston’s operations from the budgeted 110,000 units of Xoff, to a budgeted 170,000 units. It is believed that this can be accomplished by increasing Boston’s fixed regional promotional expenditures by $120,000.

- **Plan B** — Close the Boston plant and expand Chicago’s operations from the current budgeted 200,000 units of Xoff, to 310,000 units, in order to fill Boston’s budgeted production of 110,000 units. The Boston region would continue to incur promotional costs in order to sell the 110,000 units. All sales and costs would be budgeted through the Chicago plant.

- **Plan C** — Close the Boston plant and enter into a long-term contract with a competitor to serve the Boston region’s customers. This competitor would pay Poe a royalty of $2.50 per unit of Xoff sold. Poe would continue to incur fixed regional promotional costs in order to maintain sales of 110,000 units in the Boston region.

**Required:**

a. Without considering the effects of implementing Plans A, B, and C, compute the number of units of Xoff required by the Boston plant to cover its fixed factory overhead costs and fixed regional promotional costs.
b. Prepare a schedule by plant, and in total, computing Poe's budgeted contribution margin and operating income resulting from the implementation of each of the following plans:

1. Plan A.
2. Plan B.
3. Plan C.

2M84
Number 4

Number 4 consists of two unrelated parts.

Part a. Mat Company’s cost of goods sold for the month ended March 31, 1984, was $345,000. Ending work in process inventory was 90% of beginning work in process inventory. Factory overhead applied was 50% of direct labor cost. Other information pertaining to Mat Company’s inventories and production for the month of March is as follows:

<table>
<thead>
<tr>
<th>Beginning inventories — March 1</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Work in process</td>
<td>40,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>102,000</td>
</tr>
</tbody>
</table>

Required:
1. Prepare a schedule of cost of goods manufactured for the month of March.
2. Prepare a schedule to compute the prime cost incurred during March.
3. Prepare a schedule to compute the conversion cost charged to work in process during March.

2M84
Number 5 (Estimated time — 40 to 50 minutes)

At the beginning of 1984, Beal Company adopted the following standards:

<table>
<thead>
<tr>
<th></th>
<th>Input</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>3 lbs. @ $2.50 per lb.</td>
<td>$ 7.50</td>
</tr>
<tr>
<td>Direct labor</td>
<td>5 hrs. @ $7.50 per hr.</td>
<td>37.50</td>
</tr>
<tr>
<td>Factory overhead:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>$3.00 per direct labor hour</td>
<td>15.00</td>
</tr>
<tr>
<td>Fixed</td>
<td>$4.00 per direct labor hour</td>
<td>20.00</td>
</tr>
<tr>
<td>Standard cost per unit</td>
<td></td>
<td>$80.00</td>
</tr>
</tbody>
</table>

Normal volume per month is 40,000 standard labor hours. Beal’s January 1984 budget was based on normal volume. During January Beal produced 7,800 units, with records indicating the following:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials purchased</td>
<td>25,000 lbs. @ $2.60</td>
</tr>
<tr>
<td>Direct materials used</td>
<td>23,100 lbs.</td>
</tr>
<tr>
<td>Direct labor</td>
<td>40,100 hrs. @ $7.30</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

Required:

a. Prepare a schedule of budgeted production costs for January 1984, based on actual production of 7,800 units.

b. For the month of January 1984, compute the following variances, indicating whether each is favorable or unfavorable:
1. Direct materials price variance, based on purchases.
2. Direct materials usage variance.
3. Direct labor rate variance.
4. Direct labor efficiency variance.
5. Factory overhead spending variance.
6. Variable factory overhead efficiency variance.
7. Factory overhead volume variance.

AP-175
2M83
Number 4 (Estimated time — 45 to 55 minutes)

Melford Hospital operates a general hospital, but rents space and beds to separately owned entities rendering specialized services such as pediatrics and psychiatry. Melford charges each separate entity for common services such as patients' meals and laundry and for administrative services such as billings and collections. Space and bed rentals are fixed charges for the year, based on bed capacity rented to each entity.

Melford charged the following costs to pediatrics for the year ended June 30, 1982:

<table>
<thead>
<tr>
<th>Patient days</th>
<th>Bed capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Variable)</td>
<td>(Fixed)</td>
</tr>
<tr>
<td>Dietary</td>
<td>$ 600,000</td>
</tr>
<tr>
<td>Janitorial</td>
<td>—</td>
</tr>
<tr>
<td>Laundry</td>
<td>300,000</td>
</tr>
<tr>
<td>Laboratory</td>
<td>450,000</td>
</tr>
<tr>
<td>Pharmacy</td>
<td>350,000</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>—</td>
</tr>
<tr>
<td>General and administrative</td>
<td>—</td>
</tr>
<tr>
<td>Rent</td>
<td>—</td>
</tr>
<tr>
<td>Billings and collections</td>
<td>300,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

During the year ended June 30, 1982, pediatrics charged each patient an average of $300 per day, had a capacity of 60 beds, and had revenue of $6,000,000 for 365 days.

In addition, pediatrics directly employed the following personnel:

<table>
<thead>
<tr>
<th>Annual salaries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supervising nurses</td>
</tr>
<tr>
<td>Nurses</td>
</tr>
<tr>
<td>Aides</td>
</tr>
</tbody>
</table>

Melford has the following minimum departmental personnel requirements based on total annual patient days:

<table>
<thead>
<tr>
<th>Annual patient days</th>
<th>Aides</th>
<th>Nurses</th>
<th>Supervising nurses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 21,900</td>
<td>20</td>
<td>10</td>
<td>4</td>
</tr>
<tr>
<td>21,901 to 26,000</td>
<td>26</td>
<td>13</td>
<td>4</td>
</tr>
<tr>
<td>26,001 to 29,200</td>
<td>30</td>
<td>15</td>
<td>4</td>
</tr>
</tbody>
</table>

These staffing levels represent full-time equivalents. Pediatrics always employs only the minimum number of required full-time equivalent personnel. Salaries of supervising nurses, nurses, and aides are therefore fixed within ranges of annual patient days.

Pediatrics operated at 100% capacity on 90 days during the year ended June 30, 1982. It is estimated that during these 90 days the demand exceeded 20 patients more than capacity. Melford has an additional 20 beds available for rent for the year ending June 30, 1983. Such additional rental would increase pediatrics' fixed charges based on bed capacity.

Required:

a. Calculate the minimum number of patient days required for pediatrics to break even for the year ending June 30, 1983, if the additional 20 beds are not rented. Patient demand is unknown, but assume that revenue per patient day, cost per patient day, cost per bed, and salary rates will remain the same as for the year ended June 30, 1982.

b. Assume that patient demand, revenue per patient day, cost per patient day, cost per bed, and salary rates for the year ending June 30, 1983, remain the same as for the year ended June 30, 1982. Prepare a schedule of increase in revenue and increase in costs for the year ending June 30, 1983, in order to determine the net increase or decrease in earnings from the additional 20 beds if pediatrics rents this extra capacity from Melford.

2M82
Number 5 (Estimated time — 40 to 50 minutes)

Number 5 consists of two unrelated parts.

Part a. Lares Confectioners, Inc., makes a candy bar called Rey, which sells for $.50 per pound. The manufacturing process also yields a product known as Nagu. Without further processing, Nagu sells for $.10 per pound. With further processing, Nagu sells for $.30 per pound. During the month of April, total joint manufacturing costs up to the point of separation consisted of the following charges to work in process:

- Raw materials $150,000
- Direct labor 120,000
- Factory overhead 30,000

Production for the month aggregated 394,000 pounds of Rey and 30,000 pounds of Nagu. To complete Nagu during the month of April and obtain a selling price of $.30 per pound, further processing of Nagu during April would entail the following additional costs:

- Raw materials $2,000
- Direct labor 1,500
- Factory overhead 500

Required:

Prepare the April journal entries for Nagu, if Nagu is:

1. Transferred as a by-product at sales value to the warehouse without further processing, with a corresponding reduction of Rey's manufacturing costs.

AP-176
2. Further processed as a by-product and transferred to the warehouse at net realizable value, with a corresponding reduction of Rey's manufacturing costs.

3. Further processed and transferred to finished goods, with joint costs being allocated between Rey and Nagu based on relative sales value at the split-off point.

**Part b.** The following information was available from Montero Corporation's books:

<table>
<thead>
<tr>
<th>1982</th>
<th>Purchases</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan.</td>
<td>$42,000</td>
<td>$72,000</td>
</tr>
<tr>
<td>Feb.</td>
<td>48,000</td>
<td>66,000</td>
</tr>
<tr>
<td>Mar.</td>
<td>36,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Apr.</td>
<td>54,000</td>
<td>78,000</td>
</tr>
</tbody>
</table>

Collections from customers are normally 70% in the month of sale, 20% in the month following the sale, and 9% in the second month following the sale. The balance is expected to be uncollectible. Montero takes full advantage of the 2% discount allowed on purchases paid for by the tenth of the following month. Purchases for May are budgeted at $60,000, while sales for May are forecasted at $66,000. Cash disbursements for expenses are expected to be $14,400 for the month of May. Montero's cash balance at May 1 was $22,000.

**Required:**
Prepare the following schedules:

1. Expected cash collections during May.
2. Expected cash disbursements during May.

**2M81**
**Number 4 (Estimated time — — 45 to 55 minutes)**

Armando Corporation manufactures a product with the following standard costs:

- Direct materials - 20 yards @ $1.35 per yard $27
- Direct labor - 4 hours @ $9.00 per hour 36
- Factory overhead - applied at five-sixths of direct labor. Ratio of variable costs to fixed costs: 2 to 1 30

**Total standard cost per unit of output $93**

Standards are based on normal monthly production involving 2,400 direct labor hours (600 units of output).

The following information pertains to the month of July 1981:

Direct materials purchased - 18,000 yards @ $1.38 per yard $24,840

Direct materials used - 9,500 yards
Direct labor - 2,100 hours @ $9.15 per hour 19,215
Actual factory overhead 16,650

500 units of the product were actually produced in July 1981.

**Required:**
Prepare the following schedules computing:

1. Variable factory overhead rate per direct labor hour.
2. Total fixed factory overhead based on normal activity.

b. Prepare the following schedules for the month of July 1981, indicating whether each variance is favorable or unfavorable:

1. Materials price variance (based on purchases).
3. Labor rate variance.
4. Labor efficiency variance.
5. Controllable factory overhead variance.
6. Capacity (volume) factory overhead variance.

**2M81**
**Number 5 (Estimated time — — 40 to 50 minutes)**

Vogue Fashions, Inc., manufactures ladies' blouses of one quality, produced in lots to fill each special order from its customers, department stores located in various cities. Vogue sews the particular stores' labels on the blouses. The standard costs for a dozen blouses are:

- Direct materials 24 yards @ $1.10 $26.40
- Direct labor 3 hours @ $4.90 14.70
- Manufacturing overhead 3 hours @ $4.00 12.00
- **Standard cost per dozen $53.10**

During June 1980, Vogue worked on three orders, for which the month's job cost records disclose the following:

<table>
<thead>
<tr>
<th>Lot No.</th>
<th>Units in Lot (dozens)</th>
<th>Material Used (yards)</th>
<th>Hours Worked</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>1,000</td>
<td>24,100</td>
<td>2,980</td>
</tr>
<tr>
<td>23</td>
<td>1,700</td>
<td>40,440</td>
<td>5,130</td>
</tr>
<tr>
<td>24</td>
<td>1,200</td>
<td>28,825</td>
<td>2,890</td>
</tr>
</tbody>
</table>

The following information is also available:

1. Vogue purchased 95,000 yards of material during June at a cost of $106,400. The materials price
variance is recorded when goods are purchased. All inventories are carried at standard cost.

2. Direct labor during June amounted to $55,000. According to payroll records, production employees were paid $5.00 per hour.

3. Manufacturing overhead during June amounted to $45,600.

4. A total of $576,000 was budgeted for manufacturing overhead for the year 1980, based on estimated production at the plant’s normal capacity of 48,000 dozen blouses annually. Manufacturing overhead at this level of production is 40% fixed and 60% variable. Manufacturing overhead is applied on the basis of direct labor hours.

5. There was no work in process at June 1. During June, lots 22 and 23 were completed. All material was issued for lot 24, which was 80% completed as to direct labor.

Required:

a. Prepare a schedule showing the computation of standard cost of lots 22, 23, and 24 for June 1980.

b. Prepare a schedule showing the computation of the materials price variance for June 1980. Indicate whether the variance is favorable or unfavorable.

c. Prepare a schedule showing, for each lot produced during June 1980, computations of the

   1. Materials quantity variance in yards.
   2. Labor efficiency variance in hours.
   3. Labor rate variance in dollars.

   Indicate whether each variance is favorable or unfavorable.

d. Prepare a schedule showing computations of the total controllable and noncontrollable (volume) manufacturing overhead variances for June 1980. Indicate whether the variances are favorable or unfavorable.

VIII. Not-for-Profit and Governmental Accounting

2M85
Number 5 (Estimated time — 40 to 50 minutes)

Following are the adjusted current funds trial balances of Community Association for Handicapped Children, a voluntary health and welfare organization, at June 30, 1984:

<table>
<thead>
<tr>
<th>Community Association For Handicapped Children</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADJUSTED CURRENT FUNDS TRIAL BALANCES</td>
</tr>
<tr>
<td>June 30, 1984</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Unrestricted</strong></td>
</tr>
<tr>
<td><strong>Dr.</strong></td>
</tr>
<tr>
<td><strong>Cr.</strong></td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Bequest receivable</td>
</tr>
<tr>
<td>Pledges receivable</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
</tr>
<tr>
<td>Investments (at cost, which</td>
</tr>
<tr>
<td>approximates market)</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
</tr>
<tr>
<td>Deferred revenue</td>
</tr>
<tr>
<td>Allowance for uncollectible pledges</td>
</tr>
<tr>
<td>Fund balances, July 1, 1983:</td>
</tr>
<tr>
<td>Designated</td>
</tr>
<tr>
<td>Undesignated</td>
</tr>
<tr>
<td>Restricted</td>
</tr>
<tr>
<td>Transfers of endowment fund income</td>
</tr>
<tr>
<td>Contributions</td>
</tr>
<tr>
<td>Membership dues</td>
</tr>
<tr>
<td>Program service fees</td>
</tr>
<tr>
<td>Investment income</td>
</tr>
<tr>
<td>Deaf children’s program</td>
</tr>
<tr>
<td>Blind children’s program</td>
</tr>
<tr>
<td>Management and general services</td>
</tr>
<tr>
<td>Fund-raising services</td>
</tr>
<tr>
<td>Provision for uncollectible pledges</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

AP-178
**Selected Questions**

**Required:**

a. Prepare a statement of support, revenue, and expenses and changes in fund balances, separately presenting each current fund, for the year ended June 30, 1984.


**2N84**

**Number 4 (Estimated time — 45 to 55 minutes)**

The general fund trial balance of the city of Solna at December 31, 1982, was as follows:

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 62,000</td>
</tr>
<tr>
<td>Taxes receivable — delinquent</td>
<td>46,000</td>
</tr>
<tr>
<td>Estimated uncollectible taxes — delinquent</td>
<td>$ 8,000</td>
</tr>
<tr>
<td>Stores inventory — program operations</td>
<td>18,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>28,000</td>
</tr>
<tr>
<td>Fund balance reserved for stores inventory</td>
<td>18,000</td>
</tr>
<tr>
<td>Fund balance reserved for encumbrances</td>
<td>12,000</td>
</tr>
<tr>
<td>Unreserved undesignated fund balance</td>
<td>60,000</td>
</tr>
<tr>
<td><strong>$126,000</strong></td>
<td><strong>$126,000</strong></td>
</tr>
</tbody>
</table>

Collectible delinquent taxes are expected to be collected within 60 days after the end of the year. Solna uses the “purchases” method to account for stores inventory. The following data pertain to 1983 general fund operations:

1. **Budget adopted:**

   **Revenues and other financing sources**
   - Taxes $220,000
   - Fines, forfeits, and penalties 80,000
   - Miscellaneous revenues 100,000
   - Share of bond issue proceeds 200,000
   **$600,000**

   **Expenditures and other financing uses**
   - Program operations $300,000
   - General administration 120,000
   - Stores — program operations 60,000
   - Capital outlay 80,000
   - Periodic transfer to special assessment fund 20,000
   **$580,000**

2. Taxes were assessed at an amount that would result in revenues of $220,800, after deduction of 4% of the tax levy as uncollectible.

3. **Orders placed but not received:**

   - Program operations $176,000
   - General administration 80,000
   - Capital outlay 60,000
   **$316,000**

4. The city council designated $20,000 of the unreserved undesignated fund balance for possible future appropriation for capital outlay.

AP-179
5. **Cash collections and transfer:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delinquent taxes</td>
<td>$38,000</td>
</tr>
<tr>
<td>Current taxes</td>
<td>226,000</td>
</tr>
<tr>
<td>Refund of overpayment of invoice for purchase of equipment</td>
<td>4,000</td>
</tr>
<tr>
<td>Fines, forfeits, and penalties</td>
<td>88,000</td>
</tr>
<tr>
<td>Miscellaneous revenues</td>
<td>90,000</td>
</tr>
<tr>
<td>Share of bond issue proceeds</td>
<td>200,000</td>
</tr>
<tr>
<td>Transfer of remaining fund balance of a discontinued fund</td>
<td>18,000</td>
</tr>
<tr>
<td></td>
<td><strong>$664,000</strong></td>
</tr>
</tbody>
</table>

6. **Cancelled encumbrances:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Estimated</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program operations</td>
<td>$156,000</td>
<td>$166,000</td>
</tr>
<tr>
<td>General administration</td>
<td>84,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Capital outlay</td>
<td>62,000</td>
<td>62,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$302,000</strong></td>
<td><strong>$308,000</strong></td>
</tr>
</tbody>
</table>

7. **Additional vouchers:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program operations</td>
<td>$188,000</td>
</tr>
<tr>
<td>General administration</td>
<td>38,000</td>
</tr>
<tr>
<td>Capital outlay</td>
<td>18,000</td>
</tr>
<tr>
<td>Transfer to special assessment fund</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$264,000</strong></td>
</tr>
</tbody>
</table>

8. Albert, a taxpayer, overpaid his 1983 taxes by $2,000. He applied for a $2,000 credit against his 1984 taxes. The city council granted his request.

9. Vouchers paid amounted to $580,000.

10. Stores inventory on December 31, 1983, amounted to $12,000.

**Required:**

Prepare journal entries to record the effects of the foregoing data. Omit explanations.

---

**Rapapo State University**

**CURRENT FUNDS BALANCE SHEET**

**July 31, 1982**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Fund Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrestricted:</td>
<td>Unrestricted:</td>
</tr>
<tr>
<td>Cash</td>
<td>Accounts payable  $100,000</td>
</tr>
<tr>
<td>Accounts receivable—</td>
<td>Due to other funds 40,000</td>
</tr>
<tr>
<td>tuition and fees, less</td>
<td>Deferred revenue—</td>
</tr>
<tr>
<td>allowance for doubtful</td>
<td>tuition and fees 25,000</td>
</tr>
<tr>
<td>accounts of $15,000</td>
<td>Fund balance 435,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>Total unrestricted</td>
</tr>
<tr>
<td>Total unrestricted</td>
<td><strong>600,000</strong></td>
</tr>
</tbody>
</table>
Selected Questions

Restricted:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000</td>
</tr>
<tr>
<td>Investments</td>
<td>210,000</td>
</tr>
<tr>
<td>Total restricted</td>
<td>220,000</td>
</tr>
<tr>
<td>Total current funds</td>
<td>820,000</td>
</tr>
</tbody>
</table>

Restricted:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>5,000</td>
</tr>
<tr>
<td>Fund balance</td>
<td>215,000</td>
</tr>
<tr>
<td>Total restricted</td>
<td>220,000</td>
</tr>
<tr>
<td>Total current funds</td>
<td>820,000</td>
</tr>
</tbody>
</table>

The following information pertains to the year ended July 31, 1983:

1. Cash collected from students' tuition totaled $3,000,000. Of this $3,000,000, $362,000 represented accounts receivable outstanding at July 31, 1982; $2,500,000 was for current year tuition; and $138,000 was for tuition applicable to the semester beginning in August 1983.

2. Deferred revenue at July 31, 1982 was earned during the year ended July 31, 1983.

3. Accounts receivable at July 31, 1982, which were not collected during the year ended July 31, 1983, were determined to be uncollectible and were written off against the allowance account. At July 31, 1983, the allowance account was estimated at $10,000.

4. During the year, an unrestricted appropriation of $60,000 was made by the state. This state appropriation was to be paid to Rapapo sometime in August 1983.

5. During the year, unrestricted cash gifts of $80,000 were received from alumni. Rapapo's board of trustees allocated $30,000 of these gifts to the student loan fund.

6. During the year, investments costing $25,000 were sold for $31,000. Restricted fund investments were purchased at a cost of $40,000. Investment income of $18,000 was earned and collected during the year.

7. Unrestricted general expenses of $2,500,000 were recorded in the voucher system. At July 31, 1983, the unrestricted accounts payable balance was $75,000.

8. The restricted accounts payable balance at July 31, 1982 was paid.

9. The $40,000 due to other funds at July 31, 1982 was paid to the plant fund as required.

10. One quarter of the prepaid expenses at July 31, 1982 expired during the current year, and pertained to general education expense. There was no addition to prepaid expenses during the year.

Required:

a. Prepare journal entries in summary form to record the foregoing transactions for the year ended July 31, 1983. Number each entry to correspond with the number indicated in the description of its respective transaction. Your answer sheet should be organized as follows:

<table>
<thead>
<tr>
<th>Entry no.</th>
<th>Accounts</th>
<th>Unrestricted</th>
<th>Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Debit</td>
<td>Credit</td>
</tr>
</tbody>
</table>

b. Prepare a statement of changes in fund balances for the year ended July 31, 1983.

2M83 Number 5 (Estimated time — — 40 to 50 minutes)

In 1950 a group of civic-minded merchants in Albany City organized the “Committee of 100” for the purpose of establishing the Community Sports Club, a nonprofit sports organization for local youth. Each of the Committee’s 100 members contributed $1,000 toward the Club’s capital, and in turn received a participation certificate. In addition, each participant agreed to pay dues of $200 a year for the Club’s operations. All dues have been collected in full by the end of each
fiscal year ending March 31. Members who have discontinued their participation have been replaced by an equal number of new members through transfer of the participation certificates from the former members to the new ones. Following is the Club’s trial balance at April 1, 1982:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>Investments (at market, equal to cost)</td>
<td>58,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>5,000</td>
</tr>
<tr>
<td>Land</td>
<td>10,000</td>
</tr>
<tr>
<td>Building</td>
<td>164,000</td>
</tr>
<tr>
<td>Accumulated depreciation—building</td>
<td>$130,000</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>54,000</td>
</tr>
<tr>
<td>Accumulated depreciation—furniture and equipment</td>
<td>46,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>12,000</td>
</tr>
<tr>
<td>Participation certificates (100 at $1,000 each)</td>
<td>100,000</td>
</tr>
<tr>
<td>Cumulative excess of revenue over expenses</td>
<td>12,000</td>
</tr>
<tr>
<td><strong>$300,000</strong></td>
<td><strong>$300,000</strong></td>
</tr>
</tbody>
</table>

Transactions for the year ended March 31, 1983, were as follows:

1. Collections from participants for dues $20,000
2. Snack bar and soda fountain sales 28,000
3. Interest and dividends received 6,000
4. Additions to voucher register:
   - House expenses 17,000
   - Snack bar and soda fountain 26,000
   - General and administrative 11,000
5. Vouchers paid 55,000
6. Assessments for capital improvements not yet incurred (assessed on March 20, 1983; none collected by March 31, 1983; deemed 100% collectible during year ending March 31, 1984) 10,000
7. Unrestricted bequest received 5,000

Adjustment data:

1. Investments are valued at market, which amounted to $65,000 at March 31, 1983. There were no investment transactions during the year.
2. Depreciation for the year:
   - Building $4,000
   - Furniture and equipment 8,000
3. Allocation of depreciation:
   - House expenses 9,000
   - Snack bar and soda fountain 2,000
   - General and administrative 1,000
4. Actual physical inventory at March 31, 1983, was $1,000, and pertains to the snack bar and soda fountain.

Required:

On a functional basis:

a. Record the transactions and adjustments in journal entry form for the year ended March 31, 1983. Omit explanations.

b. Prepare the appropriate all-inclusive activity statement for the year ended March 31, 1983.

2N82

Number 5 (Estimated time — 40 to 50 minutes)

The following selected information was taken from the books and records of Glendora Hospital (a voluntary hospital) as of and for the year ended June 30, 1982:

- Patient service revenue totaled $16,000,000, with allowances and uncollectible accounts amounting to $3,400,000. Other operating revenue aggregated $346,000, and included $160,000 from specific purpose funds. Revenue of $6,000,000 recognized under cost reimbursement agreements is subject to audit and retroactive adjustment by third-party payors. Estimated retroactive adjustments under these agreements have been included in allowances.
- Unrestricted gifts and bequests of $410,000 were received.
- Unrestricted income from endowment funds totaled $160,000.
- Income from board-designated funds aggregated $82,000.
- Operating expenses totaled $13,370,000, and included $500,000 for depreciation computed on the straight-line basis. However, accelerated depreciation is used to determine reimbursable costs under certain third-party reimbursement agreements. Net cost reimbursement revenue amounting to $220,000, resulting from the difference in depreciation methods, was deferred to future years.
- Also included in operating expenses are pension costs of $100,000, in connection with a noncontributory pension plan covering substantially all of Glendora’s employees. Accrued pension costs are funded currently. Prior service cost is being amortized over a period of 20 years. The actuarially computed value of vested and nonvested benefits at year-end amounted to $3,000,000 and $350,000, respectively. The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8%. The plan’s net assets available for benefits at year-end were $3,050,000.
- Gifts and bequests are recorded at fair market values when received.
- Patient service revenue is accounted for at established rates on the accrual basis.

Required:

1. Prepare a formal statement of revenues and expenses for Glendora Hospital for the year ended June 30, 1982.

AP-182
2. Draft the appropriate disclosures in separate notes accompanying the statement of revenues and expenses, referencing each note to its respective item in the statement.

**2M81**

**Number 5 (Estimated time — — 40 to 50 minutes)**

The following financial activities affecting Judbury City's general fund took place during the year ended June 30, 1981:

1. The following budget was adopted:

   Estimated revenues:
   - Property taxes $4,500,000
   - Licenses and permits 300,000
   - Fines 200,000
   
   Total $5,000,000

   Appropriations:
   - General government $1,500,000
   - Police services 1,200,000
   - Fire department services 900,000
   - Public works services 800,000
   - Acquisition of fire engines 400,000
   
   Total $4,800,000

2. Property tax bills totaling $4,650,000 were mailed. It was estimated that $300,000 of this amount will be delinquent, and $150,000 will be uncollectible.

3. Property taxes totaling $3,900,000 were collected. The $150,000 previously estimated to be uncollectible remained unchanged, but $630,000 was reclassified as delinquent. It is estimated that delinquent taxes will be collected soon enough after June 30, 1981, to make these taxes available to finance obligations incurred during the year ended June 30, 1981. There was no balance of uncollected taxes at July 1, 1980.

4. Tax anticipation notes in the face amount of $300,000 were issued.

5. Other cash collections were as follows:

   - Licenses and permits $270,000
   - Fines 200,000
   - Sale of public works equipment (original cost, $75,000) 15,000
   
   Total $485,000

6. The following purchase orders were executed:

<table>
<thead>
<tr>
<th>Total</th>
<th>Outstanding at 6/30/81</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government $1,050,000</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Police services 300,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Fire department services 150,000</td>
<td>15,000</td>
</tr>
</tbody>
</table>

   Public works services 250,000 10,000
   Fire engines 400,000 —

   Totals $2,150,000 $115,000

No encumbrances were outstanding at June 30, 1980.

7. The following vouchers were approved:

   | General government $1,440,000 |
   | Police services 1,155,000 |
   | Fire department services 870,000 |
   | Public works services 700,000 |
   | Fire engines 400,000 |

   Total $4,565,000

8. Vouchers totaling $4,600,000 were paid.

**Required:**

Prepare journal entries to record the foregoing financial activities in the general fund. Omit explanations. Ignore interest accruals.

**2M81**

**Number 4 (Estimated time — — 45 to 55 minutes)**

**Part a.** The City of Merlot operates a central garage through an Internal (Intragovernmental) Service Fund to provide garage space and repairs for all city-owned and operated vehicles. The Central Garage Fund was established by a contribution of $200,000 from the General Fund on July 1, 1977, at which time the building was acquired. The after-closing trial balance at June 30, 1979, was as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$150,000</td>
</tr>
<tr>
<td>Due from General Fund</td>
<td>20,000</td>
</tr>
<tr>
<td>Inventory of materials and supplies</td>
<td>80,000</td>
</tr>
<tr>
<td>Land</td>
<td>60,000</td>
</tr>
<tr>
<td>Building</td>
<td>200,000</td>
</tr>
<tr>
<td>Allowance for depreciation</td>
<td>10,000</td>
</tr>
<tr>
<td>— building</td>
<td></td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>56,000</td>
</tr>
<tr>
<td>Allowance for depreciation</td>
<td>12,000</td>
</tr>
<tr>
<td>— machinery and equipment</td>
<td></td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>38,000</td>
</tr>
<tr>
<td>Contribution from General Fund</td>
<td>200,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>306,000</td>
</tr>
</tbody>
</table>

$566,000 $566,000

AP-183
The following information applies to the fiscal year ended June 30, 1980:

1. Materials and supplies were purchased on account for $74,000.
2. The inventory of materials and supplies at June 30, 1980, was $58,000, which agreed with the physical count taken.
3. Salaries and wages paid to employees totaled $230,000, including related costs.
4. A billing was received from the Enterprise Fund for utility charges totaling $30,000, and was paid.
5. Depreciation of the building was recorded in the amount of $5,000. Depreciation of the machinery and equipment amounted to $8,000.
6. Billings to other departments for services rendered to them were as follows:

<table>
<thead>
<tr>
<th>Post-Closing Trial Balance</th>
<th>July 1, 1979 to June 30, 1980</th>
<th>Post-Closing Trial Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 740,000</td>
<td>$ 750,000</td>
</tr>
<tr>
<td>Taxes receivable</td>
<td>40,000</td>
<td>1,870,000</td>
</tr>
<tr>
<td>Allowance for uncollectible taxes</td>
<td>8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>132,000</td>
<td>1,852,000</td>
</tr>
<tr>
<td>Fund balance:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserved for encumbrances</td>
<td>600,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Unreserved</td>
<td>30,000</td>
<td>140,000</td>
</tr>
</tbody>
</table>

Additional information:
The budget for the fiscal year ended June 30, 1980, provided for estimated revenues of $2,000,000 and appropriations of $1,940,000.

Required:
Prepare journal entries to record the budgeted and actual transactions for the fiscal year ended June 30, 1980.
PROBLEMS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

**Ward Specialty Foods**

**WORKSHEET TO CONVERT**

**TRIAL BALANCE TO ACCRUAL BASIS**

*December 31, 1983*

<table>
<thead>
<tr>
<th></th>
<th><strong>Cash Basis</strong></th>
<th><strong>Adjustments</strong></th>
<th><strong>Accrual Basis</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 18,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allow. for doubtful accts.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td>[3] 3,000</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid rent</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td></td>
<td>[5] 600</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>4,800</td>
<td>[7] 4,000</td>
<td></td>
</tr>
<tr>
<td>Accrued expenses</td>
<td></td>
<td>[8] 1,360</td>
<td></td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>850</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ward, drawings</td>
<td>24,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>[5] 540</td>
</tr>
<tr>
<td>Sales</td>
<td>187,000</td>
<td>[7] 4,000</td>
<td>[1] 3,400</td>
</tr>
<tr>
<td>Purchases</td>
<td>82,700</td>
<td>[3] 20,000</td>
<td>[3] 23,000</td>
</tr>
<tr>
<td>Income summary — inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>2,900</td>
<td>[8] 150</td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>8,400</td>
<td>[4] 675</td>
<td></td>
</tr>
<tr>
<td>Miscellaneous exp.</td>
<td>3,900</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>2,400</td>
<td>[5] 60</td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>3,500</td>
<td>[6] 5,800</td>
<td></td>
</tr>
<tr>
<td>Doubtful accounts exp.</td>
<td></td>
<td>[2] 1,100</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>$235,300</strong></td>
<td><strong>$235,300</strong></td>
<td><strong>$45,560</strong></td>
</tr>
</tbody>
</table>

AP-185
Explanations of Adjustments

[1] To convert 1983 sales to accrual basis

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable, 12/31/83</td>
<td>$7,900</td>
</tr>
<tr>
<td>Deduct accounts receivable, 12/31/82</td>
<td>$4,500</td>
</tr>
<tr>
<td>Increase in sales</td>
<td>$3,400</td>
</tr>
</tbody>
</table>

[2] To record provision for doubtful accounts

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mary Ward, capital, 12/31/82</td>
<td>$38,915</td>
</tr>
<tr>
<td>Add net income for year</td>
<td>$49,475</td>
</tr>
<tr>
<td>Deduct drawings for year</td>
<td>$24,000</td>
</tr>
<tr>
<td>Mary Ward, capital, 12/31/83</td>
<td>$64,390</td>
</tr>
</tbody>
</table>

Explanations of Amounts

[1] To record provision for doubtful accounts (per worksheet).

[2] Computation of net income on accrual basis for the year ended 12/31/83 (per worksheet)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$190,400</td>
</tr>
<tr>
<td>Purchases</td>
<td>$86,700</td>
</tr>
<tr>
<td>Income summary-inventory</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Salaries</td>
<td>$29,635</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>$3,050</td>
</tr>
<tr>
<td>Rent</td>
<td>$7,725</td>
</tr>
<tr>
<td>Miscellaneous expenses</td>
<td>$3,900</td>
</tr>
<tr>
<td>Insurance</td>
<td>$2,340</td>
</tr>
<tr>
<td>Utilities</td>
<td>$3,675</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$5,800</td>
</tr>
<tr>
<td>Doubtful accounts</td>
<td>1,100</td>
</tr>
<tr>
<td>Net income</td>
<td>$49,475</td>
</tr>
</tbody>
</table>


[7] To convert 1983 purchases to accrual basis

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable, 12/31/83</td>
<td>$8,800</td>
</tr>
<tr>
<td>Deduct accounts payable, 12/31/82</td>
<td>$4,800</td>
</tr>
<tr>
<td>Increase in purchases</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

[8] To convert expenses to accrual basis

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll taxes</td>
<td>$400 - $250</td>
<td>$150</td>
</tr>
<tr>
<td>Salaries</td>
<td>$510 - $375</td>
<td>135</td>
</tr>
<tr>
<td>Utilities</td>
<td>$450 - $275</td>
<td>175</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,360</strong></td>
<td><strong>$900</strong></td>
</tr>
</tbody>
</table>
**Bryant Corporation**  
**Worksheet for Balance Sheet and Statement of Income**  
November 30, 1982

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Unadjusted balance</th>
<th>Adjustments</th>
<th>Adjusted balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 150,000</td>
<td></td>
<td>$ 150,000</td>
</tr>
<tr>
<td>Marketable securities, at cost</td>
<td>60,000</td>
<td></td>
<td>60,000</td>
</tr>
<tr>
<td>Allowance for reduction to market</td>
<td></td>
<td>[1] 5,000</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>450,000</td>
<td></td>
<td>450,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(59,000)</td>
<td>[2] 23,000</td>
<td>(36,000)</td>
</tr>
<tr>
<td>Inventories</td>
<td>430,000</td>
<td>[3] 12,000</td>
<td>442,000</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>15,000</td>
<td>[4] 3,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Property, plant &amp; equipment</td>
<td>426,000</td>
<td>[5] 24,000</td>
<td>450,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(40,000)</td>
<td>[6] 2,400</td>
<td>(42,400)</td>
</tr>
<tr>
<td>Research &amp; development costs</td>
<td>120,000</td>
<td>[7] 120,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,552,000</strong></td>
<td></td>
<td><strong>$1,486,600</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities &amp; Stockholders’ Equity</th>
<th>Unadjusted balance</th>
<th>Adjustments</th>
<th>Adjusted balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable &amp; accrued expenses</td>
<td>$ (592,000)</td>
<td>[5] 22,500</td>
<td>(614,500)</td>
</tr>
<tr>
<td>Estimated liability from lawsuit</td>
<td></td>
<td>[8] 50,000</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>(224,000)</td>
<td>[9] 55,160</td>
<td>(168,840)</td>
</tr>
<tr>
<td>Common stock</td>
<td>(400,000)</td>
<td></td>
<td>(400,000)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(336,000)</td>
<td>[x] 82,740</td>
<td>(253,260)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>(1,552,000)</strong></td>
<td></td>
<td><strong>(1,486,600)</strong></td>
</tr>
</tbody>
</table>

| Statement of Income | | | |
|---------------------|---------------------|---------------------|
| Net sales           | $(2,950,000)        | $2,950,000          |
| Cost of sales       | 1,670,000           | [3] 12,000          |
| Selling & administrative expenses | 650,000 | [5] 22,500 | 646,500 |
| Depreciation expense | 40,000             | [6] 2,400           |
| Research & development expense | 30,000 | [7] 120,000 | 150,000 |
| Unrealized loss on marketable securities | (40,000) | [1] 5,000 | 5,000 |
| Estimated loss from lawsuit |                   | [8] 50,000 | 50,000 |
| Provision for income taxes | 224,000 | [9] 55,160 | 168,840 |
| Net income          | $(336,000)          | [x] 82,740          | $(253,260) |
1M83

Answer 5 (cont.)

Bryant Corporation

ADJUSTING JOURNAL ENTRIES

November 30, 1982

(Not required)

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Unrealized loss on marketable securities</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Allowance to reduce marketable securities to market</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>To reduce short-term investments to market valuation ($60,000 - $55,000)</td>
<td></td>
</tr>
<tr>
<td>(2) Allowance for doubtful accounts</td>
<td>23,000</td>
</tr>
<tr>
<td>Selling and administrative expenses (bad debts)</td>
<td>23,000</td>
</tr>
<tr>
<td>To reduce allowance account to balance determined by aging of receivables ($59,000 - $36,000)</td>
<td></td>
</tr>
<tr>
<td>(3) Inventories</td>
<td>12,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>12,000</td>
</tr>
<tr>
<td>To adjust for work-in-process inventory held by outside processor</td>
<td></td>
</tr>
<tr>
<td>(4) Prepaid insurance</td>
<td>3,000</td>
</tr>
<tr>
<td>Selling and administrative expenses (insurance)</td>
<td>3,000</td>
</tr>
<tr>
<td>To adjust for nonrecognition of prepaid expense</td>
<td></td>
</tr>
<tr>
<td>(5) Selling and administrative expenses (pension)</td>
<td>22,500</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>22,500</td>
</tr>
<tr>
<td>To accrue normal pension cost (45,000 x 4/12)</td>
<td></td>
</tr>
<tr>
<td>(6) Property, plant, and equipment</td>
<td>24,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>2,400</td>
</tr>
<tr>
<td>Cost of sales (repairs &amp; maintenance)</td>
<td>24,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>2,400</td>
</tr>
<tr>
<td>To adjust for charge to repairs and maintenance of machine purchased on 6/1/82, and to record depreciation to 11/30/82 (24,000 x 20% x 6/12)</td>
<td></td>
</tr>
<tr>
<td>(7) Research and development expense</td>
<td>120,000</td>
</tr>
<tr>
<td>Research and development costs</td>
<td>120,000</td>
</tr>
<tr>
<td>To write off research and development costs in accordance with GAAP</td>
<td></td>
</tr>
<tr>
<td>(8) Estimated loss from lawsuit</td>
<td>50,000</td>
</tr>
<tr>
<td>Estimated liability from lawsuit</td>
<td>50,000</td>
</tr>
<tr>
<td>To record probable damages payable re: lawsuit for patent infringement</td>
<td></td>
</tr>
<tr>
<td>(9) Income taxes payable</td>
<td>55,160</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>55,160</td>
</tr>
<tr>
<td>To adjust provision for year ended 11/30/82 (Schedule 1)</td>
<td></td>
</tr>
</tbody>
</table>

AP-188
Unadjusted income before income taxes $560,000

Add adjustments increasing income:
- Reduction in allowance for doubtful accounts $23,000
- Work-in-process inventory at outside processor 12,000
- Recognition of prepaid insurance 3,000
- Reversal of 6/1/82 charge to repairs & maintenance 24,000

Total adjustments increasing income 62,000

Deduct adjustments decreasing income:
- Unrealized loss on marketable securities $5,000
- Pension expense 22,500
- Depreciation on machine purchased 6/1/82 2,400
- Research & development expense 120,000
- Estimated loss from lawsuit 50,000

Total adjustments decreasing income 199,900

Adjusted income before income taxes 422,100

Effective income tax rate \( \times 40\% \)

Adjusted provision for income taxes $168,840

Provision for income taxes per books $224,000

Adjusted provision for income taxes $168,840

Adjustment to reduce provision [9] $55,160
B. Income Statement

1M85
Answer 5 (10 points)

Glenn Corporation
INCOME STATEMENT
For the Year Ended December 31, 1984

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$12,500,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>7,500,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>2,425,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>2,575,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>245,000</td>
</tr>
<tr>
<td>Income before unusual or infrequent items</td>
<td>2,330,000</td>
</tr>
<tr>
<td>Unusual or infrequent items</td>
<td></td>
</tr>
<tr>
<td>Loss on litigation settlement</td>
<td>$(450,000)</td>
</tr>
<tr>
<td>Gain on sale of long-term investments</td>
<td>260,000</td>
</tr>
<tr>
<td>Income before income tax and extraordinary item</td>
<td>2,140,000</td>
</tr>
<tr>
<td>Income tax</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>840,000 [3]</td>
</tr>
<tr>
<td>Deferred</td>
<td>72,000 [2]</td>
</tr>
<tr>
<td>Income before extraordinary item</td>
<td>1,228,000</td>
</tr>
<tr>
<td>Extraordinary item — loss due to earthquake</td>
<td></td>
</tr>
<tr>
<td>(net of applicable income tax saving of $380,000)</td>
<td>570,000 [4]</td>
</tr>
<tr>
<td>Net income</td>
<td>$658,000</td>
</tr>
</tbody>
</table>

Earnings per share

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before extraordinary item</td>
<td>$5.23 [5]</td>
</tr>
<tr>
<td>Extraordinary loss</td>
<td>(2.43) *</td>
</tr>
<tr>
<td>Net income</td>
<td>$2.80 [6]</td>
</tr>
</tbody>
</table>

*Optional

b.

Glenn Corporation
RECONCILIATION OF NET INCOME TO TAXABLE INCOME PER TAX RETURN
For the Year Ended December 31, 1984

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$658,000</td>
</tr>
<tr>
<td>Add: Income tax on income before extraordinary item</td>
<td>912,000</td>
</tr>
<tr>
<td>Permanent difference — premiums on officers’ life insurance</td>
<td>140,000</td>
</tr>
<tr>
<td></td>
<td>1,710,000</td>
</tr>
<tr>
<td>Deduct: Income tax savings — extraordinary loss</td>
<td>$380,000</td>
</tr>
<tr>
<td>Timing difference — depreciation</td>
<td>180,000</td>
</tr>
<tr>
<td></td>
<td>560,000</td>
</tr>
<tr>
<td>Taxable income per tax return</td>
<td>$1,150,000</td>
</tr>
</tbody>
</table>
Unofficial Answers

1M85
Answer 5 (cont.)

Explanations of Amounts

[1] Total income tax excluding extraordinary item for 1984
   Income before income tax and extraordinary item $2,140,000
   Add permanent difference — premiums on officers' life insurance 140,000
   Income subject to tax 2,280,000
   Income tax rate \times 40\%
   Income tax excluding extraordinary item $912,000

   Depreciation per tax return $760,000
   Less depreciation per books 580,000
   Timing difference 180,000
   Income tax rate \times 40\%
   Deferred income tax $72,000

[3] Current income tax excluding extraordinary item for 1984
   Income tax excluding extraordinary item for 1984 $912,000
   Deduct deferred income tax 72,000
   Current income tax $840,000

[4] Extraordinary item — loss due to earthquake damage
   (net of income tax) for 1984
   Loss due to earthquake damage $950,000
   Income tax saving (40\% \times $950,000) 380,000
   Net of income tax effect $570,000

[5] Earnings per share on income before extraordinary item for 1984
   Income before extraordinary item $1,228,000
   Weighted average number of shares outstanding for 1984
   \[200,000 + 20,000 + 15,000 (\frac{1}{2} \times 30,000)\] 235,000
   Earnings per share $5.23

[6] Earnings per share on net income for 1984
   Net income $658,000
   Weighted average number of shares 235,000
   Earnings per share $2.80

AP-191
### Accounting Practice

**2M82**  
**Answer 4 (10 points)**

**Woodbine Circle Corporation**  
**INCOME STATEMENT**  
*For the Year Ended December 31, 1981*

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>6,200,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>3,800,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>1,800,000</td>
</tr>
<tr>
<td>Other income and expense</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(210,000)</td>
</tr>
<tr>
<td>Income from continuing</td>
<td></td>
</tr>
<tr>
<td>operations before income taxes</td>
<td>1,690,000</td>
</tr>
<tr>
<td>Income taxes (Schedule 1)</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>576,000</td>
</tr>
<tr>
<td>Deferred</td>
<td>60,000</td>
</tr>
<tr>
<td>Income from continuing</td>
<td>1,054,000</td>
</tr>
<tr>
<td>operations</td>
<td></td>
</tr>
<tr>
<td>Discontinued operations</td>
<td></td>
</tr>
<tr>
<td>(Schedule 2)</td>
<td></td>
</tr>
<tr>
<td>Operating income</td>
<td></td>
</tr>
<tr>
<td>from discontinued AL Division</td>
<td>396,000</td>
</tr>
<tr>
<td>Loss on disposal of AL Division</td>
<td></td>
</tr>
<tr>
<td>(less applicable income taxes of $264,000)</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td></td>
</tr>
<tr>
<td>of bonds payable</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
</tr>
<tr>
<td>Income before extraordinary item</td>
<td></td>
</tr>
<tr>
<td>Extraordinary item—gain on repurchase of bonds payable (less applicable income taxes of $120,000)</td>
<td>180,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$1,480,000</td>
</tr>
<tr>
<td>Earnings per share</td>
<td></td>
</tr>
<tr>
<td>From continuing operations</td>
<td>$1.054</td>
</tr>
<tr>
<td>From discontinued operations</td>
<td>.246*</td>
</tr>
<tr>
<td>Total before extraordinary item</td>
<td>1.300</td>
</tr>
<tr>
<td>From extraordinary item</td>
<td>.180*</td>
</tr>
<tr>
<td>Net income</td>
<td>$1.480</td>
</tr>
</tbody>
</table>

*Optional

---

**Schedule 1**  
**Income Taxes on Continuing Operations**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations before income taxes</td>
<td>$1,690,000</td>
</tr>
<tr>
<td>Less permanent difference—interest on municipal bonds</td>
<td>100,000</td>
</tr>
<tr>
<td>Balance subject to tax</td>
<td></td>
</tr>
<tr>
<td>Income tax rate</td>
<td>x 40%</td>
</tr>
<tr>
<td>Total income taxes on continuing operations</td>
<td>$636,000</td>
</tr>
</tbody>
</table>

**Current**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income per tax return</td>
<td>2,150,000</td>
</tr>
<tr>
<td>Less intraperiod tax allocations</td>
<td></td>
</tr>
<tr>
<td>Discontinued operations</td>
<td></td>
</tr>
<tr>
<td>Operating income</td>
<td></td>
</tr>
<tr>
<td>Loss on disposal</td>
<td></td>
</tr>
<tr>
<td>Extraordinary item</td>
<td></td>
</tr>
<tr>
<td>Gain on repurchase of bonds payable</td>
<td></td>
</tr>
<tr>
<td>Income taxable income</td>
<td></td>
</tr>
<tr>
<td>Income tax rate</td>
<td>x 40%</td>
</tr>
<tr>
<td>Total income taxes on continuing operations</td>
<td>$576,000</td>
</tr>
</tbody>
</table>

**Deferred**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation, per tax return</td>
<td>750,000</td>
</tr>
<tr>
<td>Depreciation, per books</td>
<td>600,000</td>
</tr>
<tr>
<td>Timing difference</td>
<td>150,000</td>
</tr>
<tr>
<td>Income tax rate</td>
<td>x 40%</td>
</tr>
<tr>
<td>Total income taxes on continuing operations</td>
<td>60,000</td>
</tr>
</tbody>
</table>

---

**Schedule 2**  
**Income From Operations of AL Division**  
*For the Nine Months Ended September 30, 1981 (Date of Discontinuance)*

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>900,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>300,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>800,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>140,000</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>660,000</td>
</tr>
<tr>
<td>Income taxes (at 40%)</td>
<td>264,000</td>
</tr>
<tr>
<td>Income from Operations of AL Division</td>
<td>$396,000</td>
</tr>
</tbody>
</table>
### Bergen Corporation

#### STATEMENT OF CHANGES IN FINANCIAL POSITION

*For the Year Ended December 31, 1983*

## Financial Resources Provided

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$253,000</td>
</tr>
<tr>
<td>Add back (or deduct) items that did not use working capital</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>$149,000</td>
</tr>
<tr>
<td>Amortization of bond premium</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>15,000</td>
</tr>
<tr>
<td>Gain on sale of securities</td>
<td>15,000</td>
</tr>
<tr>
<td>Gain on sale of equipment</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Total financial resources provided</td>
<td>390,000</td>
</tr>
<tr>
<td>Sale of securities</td>
<td>95,000</td>
</tr>
<tr>
<td>Proceeds of long-term note payable</td>
<td>450,000</td>
</tr>
<tr>
<td>Sale of equipment</td>
<td>33,000</td>
</tr>
<tr>
<td>Issuance of common stock to purchase land</td>
<td>100,000</td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>158,000</td>
</tr>
<tr>
<td>Total financial resources provided</td>
<td>1,226,000</td>
</tr>
</tbody>
</table>

## Financial Resources Used

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash dividends</td>
<td>30,000</td>
</tr>
<tr>
<td>Purchase of equipment</td>
<td>392,000</td>
</tr>
<tr>
<td>Prior period income tax adjustment</td>
<td>20,000</td>
</tr>
<tr>
<td>Payment under capital lease</td>
<td>25,000</td>
</tr>
<tr>
<td>Reclassification of debt</td>
<td>159,000</td>
</tr>
<tr>
<td>Purchase of land by issuance of common stock</td>
<td>100,000</td>
</tr>
<tr>
<td>Leased equipment under capital lease</td>
<td>158,000</td>
</tr>
<tr>
<td>Total financial resources used</td>
<td>884,000</td>
</tr>
<tr>
<td>Increase in working capital</td>
<td>$342,000</td>
</tr>
</tbody>
</table>
### Bergen Corporation

**STATEMENT OF CHANGES IN FINANCIAL POSITION WORKSHEET**

*For the Year Ended December 31, 1983*  
*(Not Required)*

<table>
<thead>
<tr>
<th>Assets</th>
<th>1982</th>
<th>Dr.</th>
<th>Cr.</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$1,583,000</td>
<td>[x] $ 438,000</td>
<td></td>
<td>$2,021,000</td>
</tr>
<tr>
<td>Land</td>
<td>250,000</td>
<td>[4] 100,000</td>
<td></td>
<td>350,000</td>
</tr>
<tr>
<td>Plant &amp; equipment</td>
<td>720,000</td>
<td>[6] 392,000</td>
<td>[7] $ 52,000</td>
<td>1,060,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>(170,000)</td>
<td>[7] 24,000</td>
<td>[12] 149,000</td>
<td>(295,000)</td>
</tr>
<tr>
<td>Leased equipment — capital lease</td>
<td>—</td>
<td>[9] 158,000</td>
<td></td>
<td>158,000</td>
</tr>
<tr>
<td>Marketable invest. securities</td>
<td>75,000</td>
<td>[2] 75,000</td>
<td></td>
<td>180,000</td>
</tr>
<tr>
<td>Investment in Mason, Inc.</td>
<td>180,000</td>
<td></td>
<td></td>
<td>180,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$2,638,000</td>
<td></td>
<td></td>
<td>$3,474,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities &amp; Stockholders’ Equity</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td>$ 823,000</td>
<td>[x] 96,000</td>
<td></td>
<td>$ 919,000</td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>—</td>
<td>[10] 25,000</td>
<td>[9] 158,000</td>
<td>124,000</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>500,000</td>
<td></td>
<td></td>
<td>500,000</td>
</tr>
<tr>
<td>Unamortized bond premium</td>
<td>18,000</td>
<td>[14] 2,000</td>
<td></td>
<td>16,000</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>45,000</td>
<td>[13] 15,000</td>
<td></td>
<td>60,000</td>
</tr>
<tr>
<td>Common stock, par value $20</td>
<td>600,000</td>
<td>[4] 40,000</td>
<td>[11] 9,000</td>
<td>640,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>244,000</td>
<td>[4] 60,000</td>
<td></td>
<td>304,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>408,000</td>
<td>[3] 30,000</td>
<td>[1] 253,000</td>
<td>611,000</td>
</tr>
<tr>
<td><strong>Total liabilities &amp; equity</strong></td>
<td>$2,638,000</td>
<td>$1,348,000</td>
<td>$1,348,000</td>
<td>$3,474,000</td>
</tr>
</tbody>
</table>

**Sources of Financial Resources**

- Net income: [1] $ 253,000
- Depreciation: [12] 149,000
- Amortization of bond premium: [14] (2,000)
- Deferred income taxes: [13] 15,000
- Gain on sale of securities: [2] (20,000)
- Gain on sale of equipment: [7] (5,000)
- Sale of securities: [2] 95,000
- Issuance of common stock to purchase land: [4] 100,000
- Proceeds of long-term note payable: [5] 450,000
- Sale of equipment: [7] -33,000
- Liability under capital lease: [9] 158,000

**Uses of Financial Resources**

- Cash dividends: [3] $ 30,000
- Purchase of land for common stock: [4] 100,000
- Purchase of equipment: [6] 392,000
- Prior period income tax adjustment: [8] 20,000
- Leased equipment under capital lease: [9] 158,000
- Payment under capital lease: [10] 25,000
- Reclassification of debt: [11] 159,000
- Increase in working capital: [x] 342,000

**Sources** $1,226,000  **Uses** $1,226,000
Farrell Corporation

STATEMENT OF CHANGES IN FINANCIAL POSITION (CASH BASIS)
For the Year Ended December 31, 1981

Financial resources provided

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash provided by operations</td>
<td>$141,000</td>
</tr>
<tr>
<td>Net income</td>
<td></td>
</tr>
<tr>
<td>Add (or deduct) items not affecting cash</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>$53,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>4,000</td>
</tr>
<tr>
<td>Loss on sale of equipment</td>
<td>5,000</td>
</tr>
<tr>
<td>Equity in net income of Hall, Inc.</td>
<td>(13,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>11,000</td>
</tr>
<tr>
<td>Decrease in accounts receivable</td>
<td>10,000</td>
</tr>
<tr>
<td>Increase in inventories</td>
<td>(118,000)</td>
</tr>
<tr>
<td>Increase in accounts payable and accrued expenses</td>
<td>41,000</td>
</tr>
<tr>
<td></td>
<td>(7,000)</td>
</tr>
<tr>
<td></td>
<td>134,000</td>
</tr>
</tbody>
</table>

Cash from other sources

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of equipment</td>
<td>19,000</td>
</tr>
<tr>
<td>Sale of common stock</td>
<td>23,000</td>
</tr>
<tr>
<td>Sale of treasury stock</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Financial resources not affecting cash

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuance of note payable to purchase land</td>
<td>150,000</td>
</tr>
<tr>
<td>Issuance of common stock to convert bonds</td>
<td>50,000</td>
</tr>
</tbody>
</table>

Total financial resources provided

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>401,000</td>
</tr>
</tbody>
</table>

Financial resources used

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash dividends</td>
<td>43,000</td>
</tr>
<tr>
<td>Purchase of equipment</td>
<td>63,000</td>
</tr>
</tbody>
</table>

Financial resources not affecting cash

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conversion of bonds to common stock</td>
<td>50,000</td>
</tr>
<tr>
<td>Purchase of land by issuance of note</td>
<td>150,000</td>
</tr>
</tbody>
</table>

Total financial resources used

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>306,000</td>
</tr>
</tbody>
</table>

Increase in cash

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$95,000</td>
</tr>
</tbody>
</table>

AP-195
Farrell Corporation

STATEMENT OF CHANGES IN FINANCIAL POSITION WORKSHEET (CASH BASIS)
For the Year Ended December 31, 1981
(Not Required)

<table>
<thead>
<tr>
<th>Assets</th>
<th>1980</th>
<th>Dr.</th>
<th>Cr.</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$180,000</td>
<td>(x)$95,000</td>
<td></td>
<td>$275,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>305,000</td>
<td></td>
<td>(7)$10,000</td>
<td>$205,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>430,000</td>
<td></td>
<td>(8)118,000</td>
<td>549,000</td>
</tr>
<tr>
<td>Investment in Hall, Inc.</td>
<td>60,000</td>
<td></td>
<td>(9)13,000</td>
<td>73,000</td>
</tr>
<tr>
<td>Land</td>
<td>200,000</td>
<td>(10)150,000</td>
<td></td>
<td>350,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>606,000</td>
<td></td>
<td>(15)63,000</td>
<td>669,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>(107,000)</td>
<td></td>
<td>(4)5,000</td>
<td>(112,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>20,000</td>
<td></td>
<td>(3)4,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,695,000</td>
<td></td>
<td></td>
<td>$2,043,000</td>
</tr>
</tbody>
</table>

Liabilities and stockholders' equity

| Accounts payable and accrued expenses | $563,000 | | (9)41,000 | $604,000 |
| Note payable, long-term | | | (10)150,000 | 150,000 |
| Bonds payable | 210,000 | (12)50,000 | | 160,000 |
| Deferred income taxes | 30,000 | | (6)11,000 | 41,000 |
| Common stock | 400,000 | (11)10,000 | | 430,000 |
| | | (12)20,000 | | |
| Additional paid-in capital | 175,000 | | (11)13,000 | 226,000 |
| | | (12)30,000 | | |
| | | (13)8,000 | | |
| Retained earnings | 334,000 | (14)43,000 | | 432,000 |
| Treasury stock | (17,000) | | (13)17,000 | | |
| Total liabilities and equity | $1,695,000 | $553,000 | $553,000 | $2,043,000 |

Sources of Financial Resources

<table>
<thead>
<tr>
<th>Sources</th>
<th>Uses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash provided by operations</td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>(1)$141,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(2)53,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>(3)4,000</td>
</tr>
<tr>
<td>Loss on sale of equipment</td>
<td>(4)5,000</td>
</tr>
<tr>
<td>Equity in net income of Hall, Inc.</td>
<td>(5)(13,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>(6)11,000</td>
</tr>
<tr>
<td>Decrease in accounts receivable</td>
<td>(7)10,000</td>
</tr>
<tr>
<td>Increase in inventories</td>
<td>(8)(118,000)</td>
</tr>
<tr>
<td>Increase in accounts payable and accrued expenses</td>
<td>(9)41,000</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Issuance of note payable to purchase land</td>
<td>(10)150,000</td>
</tr>
<tr>
<td>Sale of equipment</td>
<td>(4)19,000</td>
</tr>
<tr>
<td>Sale of common stock</td>
<td>(11)23,000</td>
</tr>
<tr>
<td>Issuance of common stock to convert bonds</td>
<td>(12)50,000</td>
</tr>
<tr>
<td>Sale of treasury stock</td>
<td>(13)25,000</td>
</tr>
</tbody>
</table>

Uses of Financial Resources

<table>
<thead>
<tr>
<th>Uses of Financial Resources</th>
<th>Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash dividends</td>
<td>(14)$43,000</td>
</tr>
<tr>
<td>Conversion of bonds to common stock</td>
<td>(12)50,000</td>
</tr>
<tr>
<td>Purchase of land by issuance of note</td>
<td>(10)150,000</td>
</tr>
<tr>
<td>Purchase of equipment</td>
<td>(15)63,000</td>
</tr>
<tr>
<td>Increase in cash</td>
<td>(x)95,000</td>
</tr>
<tr>
<td></td>
<td>$401,000</td>
</tr>
</tbody>
</table>

$401,000
D. Statement of Owners' Equity

1N83
Answer 4 (10 points)

1. 

**Ashwood, Inc.**

**STATEMENT OF RETAINED EARNINGS**

*For the Year Ended December 31, 1982*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 1981</td>
<td>$ 6,500,000</td>
</tr>
<tr>
<td>As originally reported</td>
<td></td>
</tr>
<tr>
<td>Add prior period adjustment from error understating inventories at December 31, 1981</td>
<td>$ 300,000</td>
</tr>
<tr>
<td>Less income tax effect</td>
<td>120,000</td>
</tr>
<tr>
<td>As restated</td>
<td>6,680,000</td>
</tr>
<tr>
<td>Net income</td>
<td>4,500,000</td>
</tr>
<tr>
<td>Deduct cash dividends</td>
<td>11,180,000</td>
</tr>
<tr>
<td>On preferred stock at required rate [4.50 ($50 × 9%) × 100,000 shares]</td>
<td>450,000</td>
</tr>
<tr>
<td>On common stock, $1.00 per share [1 × 2,480,000 shares (2,000,000 + 500,000 - 20,000)]</td>
<td>2,480,000</td>
</tr>
<tr>
<td>Balance, December 31, 1982</td>
<td>$ 8,250,000</td>
</tr>
</tbody>
</table>

2. 

**Ashwood, Inc.**

**STOCKHOLDERS' EQUITY SECTION OF BALANCE SHEET**

*December 31, 1982*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock, $50 par value, 9% cumulative, convertible, 600,000 shares authorized; 100,000 shares issued and outstanding</td>
<td>$ 5,000,000</td>
</tr>
<tr>
<td>Common stock, $10 par value; 6,000,000 shares authorized; 2,500,000 shares issued (2,000,000 + 500,000), of which 10,000 shares are held in treasury</td>
<td>25,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital from preferred stock [100,000 × $4 ($54 - $50)]</td>
<td>400,000</td>
</tr>
<tr>
<td>Additional paid-in capital from common stock (Schedule 1)</td>
<td>11,050,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>8,250,000</td>
</tr>
<tr>
<td></td>
<td>49,700,000</td>
</tr>
<tr>
<td>Less common stock in treasury, 10,000 shares at cost [16 × 10,000 (20,000 - 10,000)]</td>
<td>160,000</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>$49,540,000</td>
</tr>
</tbody>
</table>
Answer 4 (cont.)

Schedule 1

Additional Paid-In Capital From Common Stock

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 1981</td>
<td>$7,500,000</td>
</tr>
<tr>
<td>From issuance of 500,000 shares on April 30, 1982</td>
<td></td>
</tr>
<tr>
<td>[500,000 × $7 ($17 - $10)]</td>
<td>3,500,000</td>
</tr>
<tr>
<td>From sale of 10,000 shares treasury stock on November 10, 1982</td>
<td></td>
</tr>
<tr>
<td>[10,000 × $5 ($21 - $16)]</td>
<td>50,000</td>
</tr>
<tr>
<td>Balance, December 31, 1982</td>
<td>$11,050,000</td>
</tr>
</tbody>
</table>

3. Ashwood, Inc.

COMPUTATION OF BOOK VALUE PER SHARE OF COMMON STOCK

December 31, 1982

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total stockholders’ equity</td>
<td>$49,540,000</td>
</tr>
<tr>
<td>Deduct allocation to preferred stock</td>
<td></td>
</tr>
<tr>
<td>Preferred stock at liquidation value</td>
<td>5,000,000</td>
</tr>
<tr>
<td>(100,000 shares × $50)</td>
<td></td>
</tr>
<tr>
<td>Allocation to common stock</td>
<td>$44,540,000</td>
</tr>
<tr>
<td>[2,490,000 shares outstanding (2,500,000 - 10,000)]</td>
<td></td>
</tr>
<tr>
<td>Book value per share of common stock</td>
<td>$17.89</td>
</tr>
<tr>
<td>($44,540,000 ÷ 2,490,000)</td>
<td></td>
</tr>
</tbody>
</table>
### Consolidated Financial Statements or Worksheets

**Amboy Corporation and Subsidiary**

**CONSOLIDATING STATEMENT WORKSHEET**

**December 31, 1982**

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Amboy Corp.</th>
<th>Taft Inc.</th>
<th>Adjustments &amp; Eliminations*</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$(1,900,000)</td>
<td>$(1,500,000)</td>
<td>[6] $180,000</td>
<td>$(3,220,000)</td>
</tr>
<tr>
<td>Dividends from Taft</td>
<td>(40,000)</td>
<td></td>
<td>[3] 40,000</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of warehouse</td>
<td>(30,000)</td>
<td></td>
<td>[4] 30,000</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,180,000</td>
<td>870,000</td>
<td>[6] $162,000</td>
<td>1,888,000</td>
</tr>
<tr>
<td>Operating expenses (incl. deprec.)</td>
<td>550,000</td>
<td>440,000</td>
<td>[2] 12,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ (240,000)</td>
<td>$(190,000)</td>
<td>[a] 262,000</td>
<td>[a] 164,000</td>
</tr>
</tbody>
</table>

**Retained Earnings Statement**

| Balance, 1/1/82 | $ (220,000) | $(156,000) | [1] $156,000                | $ (220,000)      |
| Net income      | (240,000)   | (190,000)  | [a] 262,000                 | [a] 164,000      | (332,000)        |
| Dividends paid  |            |           | [3] 40,000                  |                  |
| Balance, 12/31/82 | $ (460,000) | $(306,000) | [b] $418,000                | [b] $204,000     | $(552,000)       |

**Balance Sheet**

<table>
<thead>
<tr>
<th>Assets:</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 285,000</td>
<td>$ 150,000</td>
<td></td>
<td>$ 435,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>430,000</td>
<td>350,000</td>
<td>[7] 75,000</td>
<td>705,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>530,000</td>
<td>410,000</td>
<td>[6] 18,000</td>
<td>922,000</td>
</tr>
<tr>
<td>Land, plant &amp; equipment</td>
<td>660,000</td>
<td>680,000</td>
<td>[1] 54,000</td>
<td>1,364,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(185,000)</td>
<td>(210,000)</td>
<td>[5] 2,000</td>
<td>(402,000)</td>
</tr>
<tr>
<td>Investment in Taft (at cost)</td>
<td>750,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td>[1] 60,000</td>
<td>1,750,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>[2] 3,000</td>
<td>57,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$ 2,470,000</td>
<td>$ 1,380,000</td>
<td></td>
<td>$3,081,000</td>
</tr>
</tbody>
</table>

| Liabilities & Stockholders' Equity: |            |           |                               |                  |
| Accounts pay. & accrued exp. | $(670,000) | $(594,000) | [7] 75,000                   | $(1,189,000)      |
| Common stock ($10 par)      | (1,200,000)| (400,000)  | [1] 400,000                  | (1,200,000)      |
| Additional paid-in capital  | (140,000)  | (80,000)   | [1] 80,000                   | (140,000)        |
| Retained earnings           | (460,000)  | (306,000)  | [b] 418,000                  | [b] 204,000      | $(552,000)       |

**Adjusted Balance**

| Adjusted Balance | $ 1,089,000 | $ 1,089,000 | $(3,081,000) |

---

**Explanations of Adjustments & Eliminations**

1. **To eliminate the reciprocal elements in investment, equity and property accounts. Amboy's investment is carried at cost at December 31, 1982.**

2. **To record amortization of current value in excess of book value of Taft's machinery at date of acquisition ($54,000 ÷ 6) and amortization of goodwill ($60,000 ÷ 20) for the year ended December 31, 1982.**

3. **To eliminate Amboy's dividend income from Taft.**

4. **To eliminate the intercompany profit on the sale of the warehouse by Amboy to Taft.**

5. **To eliminate the excess depreciation on the warehouse building sold by Amboy to Taft ([($86,000 - $66,000) ÷ 5] × ½).**

6. **To eliminate intercompany sales from Taft to Amboy and the intercompany profit in Amboy's ending inventory as follows:**

   - **Sales**
     - Total: $180,000
     - On hand: $36,000
   - **Gross profit**
     - Total: 92,000
     - On hand: 18,000

7. **To eliminate Amboy's intercompany balance for merchandise owed to Taft.**
II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

2N83
Answer 5 (10 points)

a. Winsor Company

SCHEDULE OF CURRENT MARKETABLE EQUITY SECURITIES
December 31, 1983

<table>
<thead>
<tr>
<th>Number of shares</th>
<th>Cost</th>
<th>Market price per share</th>
<th>Market value</th>
<th>Unrealized gross gain or (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bea—preferred</td>
<td>500</td>
<td>$20,000</td>
<td>$56</td>
<td>$28,000</td>
</tr>
<tr>
<td>Bea—common</td>
<td>1,500</td>
<td>20,000</td>
<td>20</td>
<td>30,000</td>
</tr>
<tr>
<td>Cha—common</td>
<td>3,500</td>
<td>35,000</td>
<td>11</td>
<td>38,500</td>
</tr>
<tr>
<td>Dey—common</td>
<td>1,700</td>
<td>42,500</td>
<td>22</td>
<td>37,400</td>
</tr>
</tbody>
</table>

$117,500          $133,900          $16,400

Valuation allowance -0-
Carried at cost $117,500

The valuation allowance of $7,000 at December 31, 1982 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. This $7,000 unrealized gain should be included in Winsor's income statement for the year ended December 31, 1983.

b. Winsor Company

SCHEDULE OF NONCURRENT MARKETABLE EQUITY SECURITIES
December 31, 1983

Eddie Corp.—100,000 shares of common stock:

Cost:
- In underlying equity: $1,400,000
- In excess of underlying equity: $300,000
- Less amortization of excess of cost over underlying equity: (7,500)

Net cost: 1,692,500

Increase in equity during 1983:
- Equity in Eddie's earnings: 360,000
- Less dividends received: (200,000)

Carrying amount of Eddie Corp. investment: 1,852,500
Unofficial Answers

2N83
Answer 5 (cont.)

Winson Company
SCHEDULE OF INVESTMENT INCOME
For the Year Ended December 31, 1983

Dividends:

- Bea Corp.—preferred (1,000 shares × $2.40 per share) $ 2,400
- Cha, Inc.—common (3,500 shares × $1.00 per share) 3,500
  Total dividend income $ 5,900

Realized gain (loss) on sale of securities:

- Cha, Inc.—common ($13 — $10 = $3 × 2,500 shares) $ 7,500
- Dey 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

Unrealized gain on current marketable equity securities (see Required a.) $ 7,000

Equity in income of Eddie Corp.

- Winson's 30% interest in Eddie's net income of $1,200,000 $360,000
- Amortization of excess of cost over underlying equity (7,500)
  Equity in income of Eddie Corp. $352,500

1M81
Answer 4 (10 points)

Part a.

Warner, Inc.
INCOME BEFORE INCOME TAXES FROM BOND INVESTMENT
For the Years Ended December 31, 1979 and 1980

<table>
<thead>
<tr>
<th>Schedule 1</th>
<th>Interest Income Before Amortization for 1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face value of bonds (800 × $1,000)</td>
<td>$800,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>× 8%</td>
</tr>
<tr>
<td>Interest for year</td>
<td>$ 64,000</td>
</tr>
<tr>
<td>Interest received December 1, 1979</td>
<td>$32,000</td>
</tr>
<tr>
<td>(64,000 × 1/2)</td>
<td></td>
</tr>
<tr>
<td>Interest accrued at December 31, 1979</td>
<td>5,333</td>
</tr>
<tr>
<td>(64,000 × 1/12)</td>
<td></td>
</tr>
<tr>
<td>Interest income before amortization for 1979</td>
<td>$37,333</td>
</tr>
</tbody>
</table>

Schedule 2

<table>
<thead>
<tr>
<th>Interest Income Before Amortization for 1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest accrued at December 31, 1979, reversed</td>
</tr>
<tr>
<td>Interest received June 1, 1980 (6 months)</td>
</tr>
<tr>
<td>Accrued interest paid by buyer (June 1 to November 1, 5/12 × $64,000)</td>
</tr>
<tr>
<td>Interest income before amortization for 1980</td>
</tr>
</tbody>
</table>

Income before income taxes $43,108

AP-201
Schedule 3

Amortization of Bond Discount—Effective Interest

Method for 1979 and 1980

<table>
<thead>
<tr>
<th>Description</th>
<th>1979</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face value of bonds (800 × $1,000)</td>
<td>$800,000</td>
<td></td>
</tr>
<tr>
<td>Purchase price of bonds</td>
<td>738,300</td>
<td></td>
</tr>
<tr>
<td>Bond discount</td>
<td>61,700</td>
<td></td>
</tr>
<tr>
<td>Amortization of bond discount for 1979</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 months ended December 1, 1979 ($738,300 × 5% =</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$36,915 effective interest − $32,000 cash interest)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$4,915</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Month of December 1979</td>
<td></td>
<td></td>
</tr>
<tr>
<td>[$743,215 ($738,300 + $4,915) × 5% = $37,161</td>
<td></td>
<td></td>
</tr>
<tr>
<td>effective interest − $32,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>cash interest = $5,161 × 1/6]</td>
<td>860</td>
<td>5,775</td>
</tr>
<tr>
<td>Balance of unamortized bond discount December 31, 1979</td>
<td>55,925</td>
<td></td>
</tr>
<tr>
<td>Amortization of bond discount for 1980</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 months ended June 1, 1980 ($5,161 − $860)</td>
<td></td>
<td>4,301</td>
</tr>
<tr>
<td>5 months ended November 1, 1980 [$748,376 ($743,215 +</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$5,161) × 5% = $37,419</td>
<td></td>
<td></td>
</tr>
<tr>
<td>effective interest − $32,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>cash interest = $5,419 × 5/6]</td>
<td>4,516</td>
<td>8,817</td>
</tr>
<tr>
<td>Balance of unamortized bond discount November 1, 1980</td>
<td></td>
<td>$47,108</td>
</tr>
</tbody>
</table>

Schedule 4

Gain on Sale of Bonds for 1980

<table>
<thead>
<tr>
<th>Description</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price of bonds</td>
<td>$785,000</td>
</tr>
<tr>
<td>Selling price of bonds, including accrued interest</td>
<td></td>
</tr>
<tr>
<td>paid by buyer (Schedule 2)</td>
<td>(26,667)</td>
</tr>
<tr>
<td>Accrued interest paid by buyer (Schedule 2)</td>
<td></td>
</tr>
<tr>
<td>Selling price of bonds</td>
<td>$758,333</td>
</tr>
<tr>
<td>Book value of bonds</td>
<td></td>
</tr>
<tr>
<td>Purchase price of bonds</td>
<td>738,300</td>
</tr>
<tr>
<td>Amortization of bond discount for 1979 (Schedule 3)</td>
<td>5,775</td>
</tr>
<tr>
<td>Amortization of bond discount for 1980 (Schedule 3)</td>
<td>8,817</td>
</tr>
<tr>
<td>Book value of bonds at date of sale</td>
<td>752,892</td>
</tr>
<tr>
<td>Gain on sale of bonds</td>
<td>$5,441</td>
</tr>
</tbody>
</table>
Unofficial Answers

Warner, Inc.

SCHEDULE OF INTEREST INCOME AND BOND DISCOUNT
AMORTIZATION—EFFECTIVE INTEREST METHOD
8% Bonds Purchased to Yield 10%
(Not Required)

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash interest (4% semiannual)</th>
<th>Effective interest (5% semiannual)</th>
<th>Discount amortization</th>
<th>Balance unamortized discount</th>
<th>Carrying value of bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>6–1–79</td>
<td>$32,000</td>
<td>$36,915</td>
<td>$4,915</td>
<td>$61,700^b</td>
<td>$738,300^a</td>
</tr>
<tr>
<td>12–1–79</td>
<td>$32,000</td>
<td>$37,161</td>
<td>5,161</td>
<td>56,785</td>
<td>743,215</td>
</tr>
<tr>
<td>6–1–80</td>
<td>32,000</td>
<td>37,419</td>
<td>5,419</td>
<td>51,624</td>
<td>748,376</td>
</tr>
<tr>
<td>12–1–80</td>
<td>32,000</td>
<td>37,690</td>
<td>5,690</td>
<td>46,205</td>
<td>753,795</td>
</tr>
<tr>
<td>6–1–81</td>
<td>32,000</td>
<td>37,974</td>
<td>5,974</td>
<td>40,515</td>
<td>759,485</td>
</tr>
<tr>
<td>12–1–81</td>
<td>32,000</td>
<td>38,273</td>
<td>6,273</td>
<td>34,541</td>
<td>765,459</td>
</tr>
<tr>
<td>6–1–82</td>
<td>32,000</td>
<td>38,587</td>
<td>6,587</td>
<td>28,268</td>
<td>771,732</td>
</tr>
<tr>
<td>12–1–82</td>
<td>32,000</td>
<td>38,916</td>
<td>6,916</td>
<td>21,681</td>
<td>778,319</td>
</tr>
<tr>
<td>6–1–83</td>
<td>32,000</td>
<td>39,262</td>
<td>7,262</td>
<td>14,765</td>
<td>785,235</td>
</tr>
<tr>
<td>12–1–83</td>
<td>32,000</td>
<td>39,625</td>
<td>7,625</td>
<td>7,503</td>
<td>792,497</td>
</tr>
<tr>
<td>6–1–84</td>
<td>$32,000</td>
<td>(122)c</td>
<td>122c</td>
<td>800,000</td>
<td></td>
</tr>
<tr>
<td>12–1–84</td>
<td>$32,000</td>
<td>(122)c</td>
<td>122c</td>
<td>800,000</td>
<td></td>
</tr>
<tr>
<td>Date</td>
<td>Cash interest (4% semiannual)</td>
<td>Effective interest (5% semiannual)</td>
<td>Discount amortization</td>
<td>Balance unamortized discount</td>
<td>Carrying value of bonds</td>
</tr>
<tr>
<td>6–1–84</td>
<td>—</td>
<td>(122)c</td>
<td>122c</td>
<td>800,000</td>
<td></td>
</tr>
<tr>
<td>12–1–84</td>
<td>—</td>
<td>(122)c</td>
<td>122c</td>
<td>800,000</td>
<td></td>
</tr>
</tbody>
</table>

^ Price paid for $800,000 bonds equals present value of principal plus present value of interest payments:
Principal $800,000 × .614 (present value of $1, at 5% for 10 periods) $491,200
Interest payments $32,000 (4% × $800,000) × 7.722 (present value of an annuity of $1 at 5% for 10 periods). $247,100
$738,300

^ $800,000 − $738,300 = $61,700.
^ Adjustment for fractional differences.

Part b.

1. Jeffries, Inc.
   INCOME BEFORE INCOME TAXES FROM INVESTMENT IN WOLF COMPANY
   For the Year Ended December 31, 1979

   October 1, 1979—dividend received from Wolf Company (10,000 shares × $0.90) $9,000

2. Jeffries, Inc.
   INCOME BEFORE INCOME TAXES FROM INVESTMENT IN WOLF COMPANY
   For the Years Ended December 31, 1980, and 1979, Restated

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1979 Restated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity in earnings of Wolf Company (Schedule 1)</td>
<td>$110,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Amortization of goodwill (Schedule 2)</td>
<td>(6,875)</td>
<td>(2,500)</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>$103,125</td>
<td>$37,500</td>
</tr>
</tbody>
</table>

AP-203
Schedule 1
Equity in Earnings of Wolf Company

<table>
<thead>
<tr>
<th>Year ended</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1979</td>
<td>40,000</td>
</tr>
<tr>
<td>December 31, 1980</td>
<td>30,000</td>
</tr>
<tr>
<td>Total</td>
<td>110,000</td>
</tr>
</tbody>
</table>

Schedule 2
Amortization of Goodwill

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of 10% investment in Wolf common stock (January 1, 1979)</td>
<td>700,000</td>
</tr>
<tr>
<td>Deduct underlying equity in net assets of Wolf at January 1, 1979 ($6,000,000 x 10%)</td>
<td>600,000</td>
</tr>
<tr>
<td>Goodwill on 10% investment</td>
<td>100,000</td>
</tr>
<tr>
<td>Amortization rate (40 years)</td>
<td>× 2.5%</td>
</tr>
<tr>
<td>Annual amortization of goodwill</td>
<td>2,500</td>
</tr>
<tr>
<td>Amortization for year ended December 31, 1979</td>
<td>2,500</td>
</tr>
<tr>
<td>Cost of 30% investment in Wolf common stock (July 1, 1980)</td>
<td>2,300,000</td>
</tr>
<tr>
<td>Deduct underlying equity in net assets of Wolf at July 1, 1980 ($6,500,000 x 30%)</td>
<td>1,950,000</td>
</tr>
<tr>
<td>Goodwill on 30% investment</td>
<td>350,000</td>
</tr>
<tr>
<td>Amortization rate (40 years)</td>
<td>× 2.5%</td>
</tr>
<tr>
<td>Annual amortization of goodwill</td>
<td>8,750</td>
</tr>
<tr>
<td>Amortization for year ended December 31, 1980</td>
<td>6,875</td>
</tr>
</tbody>
</table>

B. Receivables and Accruals

1M84
Answer 5 (10 points)

1.

Linden, Inc.
LONG-TERM RECEIVABLES SECTION
OF BALANCE SHEET
December 31, 1983

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>9% note receivable from sale of division, due in annual installments of $500,000 to May 1, 1985, less current installment</td>
<td>500,000 [1]</td>
</tr>
<tr>
<td>8% note receivable from officer, due December 31, 1985, collateralized by 10,000 shares of Linden, Inc., common stock with a fair value of $450,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Non-interest-bearing note from sale of patent, net of 15% imputed interest, due April 1, 1985</td>
<td>84,105 [2]</td>
</tr>
<tr>
<td>Installment contract receivable, due in annual installments of $50,000 to July 1, 1987, less current installment</td>
<td>112,400 [3]</td>
</tr>
<tr>
<td>Total long-term receivables</td>
<td>$1,096,505</td>
</tr>
</tbody>
</table>
2.

Linden, Inc.

SELECTED BALANCE SHEET BALANCES
December 31, 1983

Current portion of long-term receivables:
Note receivable from sale of division $500,000 [1]
Installment contract receivable 27,600 [3]
Total $527,600

Accrued interest receivable:
Note receivable from sale of division $60,000 [4]
Installment contract receivable 11,200 [5]
Total $71,200

3.

Linden, Inc.

INTEREST INCOME FROM LONG-TERM RECEIVABLES
AND GAINS RECOGNIZED ON SALE OF ASSETS
For the Year Ended December 31, 1983

Interest income:
Note receivable from sale of division $105,000 [6]
Note receivable from sale of patent 8,505 [2]
Note receivable from officer 32,000 [7]
Installment contract receivable from sale of land 11,200 [5]
Total interest income for year ended 12/31/83 $156,705

Gains recognized on sale of assets:
Patent $37,600 [8]
Land 50,000 [9]
Total gains recognized for year ended 12/31/83 $87,600

Explanations of Amounts

[1] Long-term Portion of 9% Note Receivable at 12/31/83
   Face amount, 5/1/82 $1,500,000
   Less installment received 5/1/83 500,000
   Balance, 12/31/83 1,000,000
   Less installment due 5/1/84 500,000
   Long-term portion, 12/31/83 $500,000

[2] Non-interest-bearing Note, Net of Imputed Interest at 12/31/83
   Face amount, 4/1/83 $100,000
   Less imputed interest
   [$100,000 — ($100,000 × 0.756)] 24,400
   Balance, 4/1/83 75,600
   Add interest earned to 12/31/83
   ($75,600 × 15% × $/12) 8,505
   Balance, 12/31/83 $84,105
### Long-term Portion of Installment Contract Receivable at 12/31/83

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract selling price, 7/1/83</td>
<td>$200,000</td>
</tr>
<tr>
<td>Less down payment, 7/1/83</td>
<td>$60,000</td>
</tr>
<tr>
<td>Balance, 12/31/83</td>
<td>$140,000</td>
</tr>
<tr>
<td>Less installment due, 7/1/84</td>
<td></td>
</tr>
<tr>
<td>[$50,000 — ($140,000 x 16%)]</td>
<td>$27,600</td>
</tr>
<tr>
<td>Long-term portion, 12/31/83</td>
<td>$112,400</td>
</tr>
</tbody>
</table>

### Accrued Interest — Note Receivable, Sale of Division, at 12/31/83

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest accrued from 5/1 to 12/31/83 ($1,000,000 x 9% x 8/12)</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

### Accrued Interest — Installment Contract at 12/31/83

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest accrued from 7/1 to 12/31/83 ($140,000 x 16% x 1/2)</td>
<td>$11,200</td>
</tr>
</tbody>
</table>

### Interest Income — Note Receivable, Sale of Division, for 1983

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest earned from 1/1 to 5/1/83 ($1,500,000 x 9% x 4/12)</td>
<td>$45,000</td>
</tr>
<tr>
<td>Interest earned from 5/1 to 12/31/83 ($1,000,000 x 9% x 8/12)</td>
<td>$60,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>$105,000</td>
</tr>
</tbody>
</table>

### Interest Income — Note Receivable, Officer, for 1983

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest earned 1/1 to 12/31/83 ($400,000 x 8%)</td>
<td>$32,000</td>
</tr>
</tbody>
</table>

### Gain Recognized on Sale of Patent

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated selling price</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less imputed interest</td>
<td>$24,400</td>
</tr>
<tr>
<td>Actual selling price</td>
<td>75,600</td>
</tr>
<tr>
<td>Less cost of patent (net)</td>
<td></td>
</tr>
<tr>
<td>Carrying value 1/1/83</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less amortization 1/1 to 4/1/84 ($8,000 x 1/4)</td>
<td>2,000</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>38,000</td>
</tr>
<tr>
<td></td>
<td>$37,600</td>
</tr>
</tbody>
</table>

### Gain Recognized on Sale of Land

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$200,000</td>
</tr>
<tr>
<td>Less cost</td>
<td>150,000</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
Part a.

Harris Corporation

ANALYSIS OF CHANGES IN THE
ALLOWANCE FOR DOUBTFUL ACCOUNTS
For the Year Ended December 31, 1982

Balance at January 1, 1982
Provision for doubtful accounts ($9,000,000 × 2%)
Recovery in 1982 of bad debts written off previously

Deduct write-offs for 1982 ($90,000 + $60,000)
Balance at December 31, 1982, before change in accounting estimate
Increase due to change in accounting estimate during 1982 ($235,300 − $175,000)
Balance at December 31, 1982, adjusted (Schedule 1)

Schedule 1

Computation of Allowance for Doubtful Accounts
at December 31, 1982

<table>
<thead>
<tr>
<th>Aging category</th>
<th>Balance</th>
<th>Percent</th>
<th>Doubtful accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>November–December 1982</td>
<td>$1,140,000</td>
<td>2</td>
<td>$ 22,800</td>
</tr>
<tr>
<td>July–October</td>
<td>600,000</td>
<td>10</td>
<td>60,000</td>
</tr>
<tr>
<td>January–June</td>
<td>400,000</td>
<td>25</td>
<td>100,000</td>
</tr>
<tr>
<td>Prior to 1/1/82</td>
<td>70,000a</td>
<td>75</td>
<td>52,500</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$235,300</td>
</tr>
</tbody>
</table>

2. Harris Corporation

JOURNAL ENTRY
December 31, 1982

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision for doubtful accounts</td>
<td>$60,300</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td></td>
<td>$60,300</td>
</tr>
</tbody>
</table>

To increase the allowance for doubtful accounts
at December 31, 1982, resulting from a change
in accounting estimate.
C. Inventories

1M83
Answer 4

Part b.
1. Lucas Distributors, Inc.

COMPUTATION OF INTERNAL CONVERSION PRICE INDEX
FOR INVENTORY POOL NO. 1
DOUBLE EXTENSION METHOD

<table>
<thead>
<tr>
<th></th>
<th>December 31, 1981</th>
<th>December 31, 1982</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current inventory at current year cost</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product A</td>
<td>17,000 \times $35 = $595,000</td>
<td>13,000 \times $40 = $520,000</td>
</tr>
<tr>
<td>Product B</td>
<td>9,000 \times $28 = 252,000</td>
<td>10,000 \times $32 = 320,000</td>
</tr>
<tr>
<td></td>
<td>$847,000</td>
<td>$840,000</td>
</tr>
<tr>
<td>Current inventory at base cost</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product A</td>
<td>17,000 \times $30 = $510,000</td>
<td>13,000 \times $30 = $390,000</td>
</tr>
<tr>
<td>Product B</td>
<td>9,000 \times $25 = 225,000</td>
<td>10,000 \times $25 = 250,000</td>
</tr>
<tr>
<td></td>
<td>$735,000</td>
<td>$640,000</td>
</tr>
<tr>
<td>Conversion price index</td>
<td>$847,000 \div $735,000 = 1.15</td>
<td>$840,000 \div $640,000 = 1.31</td>
</tr>
</tbody>
</table>

2. Lucas Distributors, Inc.

COMPUTATION OF INVENTORY AMOUNTS UNDER DOLLAR VALUE LIFO METHOD
FOR INVENTORY POOL NO. 1
At December 31, 1981 and 1982

<table>
<thead>
<tr>
<th></th>
<th>Current inventory at base cost</th>
<th>Conversion price index</th>
<th>Inventory at LIFO cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1981</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base inventory</td>
<td>$560,000</td>
<td>1.00</td>
<td>$560,000</td>
</tr>
<tr>
<td>1981 layer ($735,000 - $560,000)</td>
<td>175,000</td>
<td>1.15&lt;sup&gt;a&lt;/sup&gt;</td>
<td>201,250</td>
</tr>
<tr>
<td>Total</td>
<td>$735,000&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
<td>$761,250</td>
</tr>
<tr>
<td>December 31, 1982</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base inventory</td>
<td>$560,000</td>
<td>1.00</td>
<td>$560,000</td>
</tr>
<tr>
<td>1981 layer (remaining)</td>
<td>80,000&lt;sup&gt;b&lt;/sup&gt;</td>
<td>1.15&lt;sup&gt;a&lt;/sup&gt;</td>
<td>92,000</td>
</tr>
<tr>
<td>1982 layer</td>
<td>0</td>
<td>1.31&lt;sup&gt;a&lt;/sup&gt;</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$640,000&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
<td>$652,000</td>
</tr>
</tbody>
</table>

<sup>a</sup> See Computation of Internal Conversion Price Index, above.

<sup>b</sup> After liquidation of $95,000 at base cost:

- Product A (4,000 \times $30) $120,000
- Product B (1,000 \times $25) (25,000)
- Net $ 95,000

AP-208
### Part a.

#### Grover Company

**COMPUTATION OF INVENTORY FOR CLASS F INVENTORY POOL UNDER LIFO METHOD**

*December 31, 1979*

<table>
<thead>
<tr>
<th>Units</th>
<th>Weighted average unit cost</th>
<th>Total cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base year inventory—1976</td>
<td>9,000</td>
<td>$10.00</td>
</tr>
<tr>
<td>Incremental layer—1977 (Portion)</td>
<td>2,000</td>
<td>11.00</td>
</tr>
<tr>
<td><strong>Inventory, December 31, 1979 (Schedule 1)</strong></td>
<td>11,000</td>
<td><strong>$112,000</strong></td>
</tr>
</tbody>
</table>

#### Schedule 1

*Computation of Units in Inventory for Class F Inventory Pool*

<table>
<thead>
<tr>
<th>Units</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, December 31, 1978</td>
<td>14,000</td>
</tr>
<tr>
<td>Add purchases during 1979 (4,800 + 7,200)</td>
<td>12,000</td>
</tr>
<tr>
<td>Inventory available for use</td>
<td>26,000</td>
</tr>
<tr>
<td>Deduct units used for production during 1979</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Inventory, December 31, 1979</strong></td>
<td>11,000</td>
</tr>
</tbody>
</table>

#### Schedule 2

*Average Unit Cost for Incremental Layer—1980*

<table>
<thead>
<tr>
<th>Units</th>
<th>Total cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase of January 10, 1980</td>
<td>7,500</td>
</tr>
<tr>
<td>Purchase of May 15, 1980</td>
<td>5,500</td>
</tr>
<tr>
<td>Purchase of December 29, 1980</td>
<td>7,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>20,000</strong></td>
</tr>
<tr>
<td>Average unit cost ($306,000 ÷ 20,000)</td>
<td></td>
</tr>
</tbody>
</table>

#### Schedule 3

*Computation of Units in Inventory for Class F Inventory Pool*

<table>
<thead>
<tr>
<th>Units</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, December 31, 1979 (Schedule 1)</td>
<td>11,000</td>
</tr>
<tr>
<td>Add purchases during 1980 (Schedule 2)</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Inventory available for use</strong></td>
<td><strong>31,000</strong></td>
</tr>
<tr>
<td>Deduct units used for production during 1980</td>
<td><strong>16,000</strong></td>
</tr>
<tr>
<td><strong>Inventory, December 31, 1980</strong></td>
<td><strong>15,000</strong></td>
</tr>
</tbody>
</table>
**Layne Corporation**  
**ADJUSTMENTS TO INITIAL AMOUNTS**  
*As of December 31, 1980*

<table>
<thead>
<tr>
<th></th>
<th><strong>Inventory</strong></th>
<th><strong>Accounts payable</strong></th>
<th><strong>Net sales</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial amounts</td>
<td>$1,750,000</td>
<td>$1,200,000</td>
<td>$8,500,000</td>
</tr>
<tr>
<td>Adjustments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Increase)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>NONE</td>
<td>NONE</td>
<td>(35,000)</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>50,000</td>
<td>NONE</td>
</tr>
<tr>
<td>3</td>
<td>20,000</td>
<td>NONE</td>
<td>NONE</td>
</tr>
<tr>
<td>4</td>
<td>26,000</td>
<td>NONE</td>
<td>(40,000)</td>
</tr>
<tr>
<td>5</td>
<td>25,000</td>
<td>NONE</td>
<td>NONE</td>
</tr>
<tr>
<td>6</td>
<td>30,000</td>
<td>NONE</td>
<td>NONE</td>
</tr>
<tr>
<td>7</td>
<td>NONE</td>
<td>60,000</td>
<td>NONE</td>
</tr>
<tr>
<td>8</td>
<td>2,000</td>
<td>4,000</td>
<td>NONE</td>
</tr>
<tr>
<td>Total adjustments</td>
<td>153,000</td>
<td>114,000</td>
<td>(75,000)</td>
</tr>
<tr>
<td>Adjusted amounts</td>
<td>$1,903,000</td>
<td>$1,314,000</td>
<td>$8,425,000</td>
</tr>
</tbody>
</table>
D. Property, Plant, and Equipment Owned or Leased

1M85
Answer 4 (10 points)

a.  

Blake Corporation

DEPRECIATION AND AMORTIZATION EXPENSE

For the Year Ended December 31, 1984

Building
Book value 1/1/84 ($1,200,000 - 263,100)
150% declining balance rate [(100% ÷ 25) x 1.5)]
   Total depreciation on building

Machinery and equipment
Balance, 1/1/84
Deduct machine destroyed by fire
Depreciation
Machine destroyed by fire, 4/1/84
Depreciation from 1/1 to 4/1/84 (10% x 3/12)

Purchased 7/1/84
Depreciation from 7/1 to 12/31/84 (10% x 6/12)
Total depreciation on machinery and equipment

Automotive equipment
Depreciation on $115,000 balance, 1/1/84
Deduct depreciation on car traded in 1/2/84
(SYD 3d year 2/10 x $9,000)
Car purchased, 1/2/84
Depreciation SYD 1st year
Total depreciation on automotive equipment

Leasehold improvements
Cost, 5/1/84
Amortization period (5/1/84 to 12/31/90) ÷ 80 mos.
Amortization per month $ 2,100
Amortization for 1984 (5/1 to 12/31/84) × 8 mos.
Total amortization on leasehold improvements
Total depreciation and amortization expense for 1984

Unofficial Answers

AP-211
Blake Corporation

ACCUMULATED DEPRECIATION AND AMORTIZATION
December 31, 1984

Accumulated depreciation — building at 12/31/84
Balance, 1/1/84 $263,100
Depreciation for 1984 56,214
Balance, 12/31/84 $319,314

Accumulated depreciation — machinery and equipment at 12/31/84
Balance, 1/1/84 $250,000
Depreciation for 1984 103,775
Deduct machine destroyed by fire (5 \times 10\% \times $23,000) 11,500
Balance, 12/31/84 $342,275

Accumulated depreciation — automotive equipment at 12/31/84
Balance, 1/1/84 $84,600
Depreciation for 1984 105,600
Deduct car traded in ($9,000 - $2,700) 6,300
Balance, 12/31/84 $99,300

Accumulated amortization — leasehold improvements at 12/31/84
Amortization for 1984 $16,800
Balance, 12/31/84 $16,800

Total accumulated depreciation and amortization at 12/31/84 $777,689

b. Blake Corporation

GAIN OR LOSS FROM DISPOSAL OF ASSETS
For the Year Ended December 31, 1984

Gain on machine destroyed by fire
Insurance recovery $15,500
Book value of machine destroyed
[$23,000 - (5 \times 10\% \times $23,000)] 11,500 $4,000

Loss on car traded in on new car purchase
Book value of car traded in $2,700
Trade-in allowed ($12,000 - $10,000) 2,000 700 $3,300

Net gain on asset disposals for 1984

AP-212
c.  

Blake Corporation  
PROPERTY, PLANT, AND EQUIPMENT SECTION  
OF BALANCE SHEET  
December 31, 1984  

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Accumulated depreciation and amortization</th>
<th>Book value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$150,000</td>
<td>$—</td>
<td>$150,000</td>
</tr>
<tr>
<td>Building</td>
<td>1,200,000</td>
<td>319,314</td>
<td>880,686</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,187,000 [1]</td>
<td>342,275</td>
<td>844,725</td>
</tr>
<tr>
<td>Automotive equipment</td>
<td>118,000 [2]</td>
<td>99,300</td>
<td>18,700</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>168,000</td>
<td>16,800</td>
<td>151,200</td>
</tr>
<tr>
<td>Totals</td>
<td>$2,823,000</td>
<td>$777,689</td>
<td>$2,045,311</td>
</tr>
</tbody>
</table>

Explanations of Amounts

[1] Machinery and equipment at 12/31/84  
Balance, 1/1/84 $900,000  
Purchased, 7/1/84 ($280,000 + $5,000 + $25,000) 310,000  
Deduct machine destroyed by fire 4/1/84 23,000  
Balance, 12/31/84 $1,187,000

[2] Automotive equipment at 12/31/84  
Balance, 1/1/84 $115,000  
Car purchased, 1/2/84 12,000  
Deduct car traded in 9,000  
Balance, 12/31/84 $118,000

1M85  
Answer 4 (cont.)

1N82  
Answer 5

Part b.  

Brock Corporation  
CAPITALIZED COST OF OFFICE BUILDING  
As of September 30, 1981

2.  

Contract cost $3,000,000  
Plans, specifications and blueprints 12,000  
Architects' fees for design and supervision 95,000  
Capitalized interest—1980 ($900,000 × 14% × 10/12) 105,000  
Capitalized interest—1981 ($2,300,000 × 14% × 9/12) 241,500  
Total capitalized cost, September 30, 1981 $3,453,500
3. **Finley Company**

**COMPUTATION OF EXPENSE ON LEASE RECORDED AS A CAPITAL LEASE**

For the Year Ended December 31, 1980

- Depreciation \( \frac{\$422,880 \text{ (Schedule 1)}}{7} \) $ 60,411
- Interest expense (Schedule 1) $ 40,817
- Total expense on lease $101,228

**Schedule 1**

Interest Expense Year Ended December 31, 1980

- Liability under capital lease (initial value) \( \left[ \$82,739 \times 5.111 \right] \) (present value of an annuity of $1 in advance for 7 periods at 12%)* $422,880
- Deduct lease payment on December 31, 1979 $ 82,739
- Balance December 31, 1979 (after initial payment) 340,141
- Interest rate \( \times 12\% \)
- Interest expense year ended December 31, 1980 $ 40,817

* Finley Company must use Dumont Corporation's (Lessor's) implicit rate of 12% (which is known to it), since it is lower than Finley's incremental borrowing rate of 14%.

1. **Dumont Corporation**

**COMPUTATION OF ANNUAL RENTAL UNDER DIRECT FINANCING LEASE**

Dated December 31, 1979

- Cost of leased machine $500,000
- Deduct investment tax credit ($500,000 \times 10\%) 50,000
- Net cost to Dumont 450,000
- Deduct present value of estimated residual value \( \left( \$60,000 \times 0.452 \right) \) (present value of $1 at 12% for 7 periods) 27,120
- Net investment to be recovered 422,880
- Present value of an annuity of $1 in advance for 7 periods at 12% \( \times 5.111 \)
- Annual rental $ 82,739

2. **Dumont Corporation**

**COMPUTATION OF GROSS LEASE RENTALS RECEIVABLE AND UNEARNED INTEREST REVENUE AT INCEPTION OF DIRECT FINANCING LEASE**

Dated December 31, 1979

- Gross lease rentals receivable \( \left( \$82,739 \times 7 \right) \) $579,173
- Deduct recovery of net investment in machine on capital lease
  - Cost of machine $500,000
  - Investment tax credit \( \left( \$500,000 \times 10\% \right) \) (50,000) 390,000
- Unearned interest revenue $189,173
SCHEDULE OF AMORTIZATION—DIRECT FINANCING LEASE

Dated December 31, 1979
(Not Required)

<table>
<thead>
<tr>
<th>Date</th>
<th>Lease Rental</th>
<th>Interest Income (12%)</th>
<th>Investment Recovery</th>
<th>Net Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>12-31-79</td>
<td>Initial Value</td>
<td>—</td>
<td>—</td>
<td>$450,000\textsuperscript{ad}</td>
</tr>
<tr>
<td>12-31-79</td>
<td>$ 82,739</td>
<td>—</td>
<td>$ 82,739</td>
<td>367,261</td>
</tr>
<tr>
<td>12-31-80</td>
<td>82,739</td>
<td>$ 44,071</td>
<td>38,668</td>
<td>328,593</td>
</tr>
<tr>
<td>12-31-81</td>
<td>82,739</td>
<td>39,431</td>
<td>43,308</td>
<td>285,285</td>
</tr>
<tr>
<td>12-31-82</td>
<td>82,739</td>
<td>34,234</td>
<td>48,505</td>
<td>236,780</td>
</tr>
<tr>
<td>12-31-83</td>
<td>82,739</td>
<td>28,414</td>
<td>54,325</td>
<td>182,455</td>
</tr>
<tr>
<td>12-31-84</td>
<td>82,739</td>
<td>21,895</td>
<td>60,844</td>
<td>121,611</td>
</tr>
<tr>
<td>12-31-85</td>
<td>82,739</td>
<td>14,593</td>
<td>68,146\textsuperscript{c}</td>
<td>53,465\textsuperscript{f}</td>
</tr>
<tr>
<td>12-31-86</td>
<td>—</td>
<td>6,416</td>
<td>(6,416)</td>
<td>59,881</td>
</tr>
<tr>
<td>12-31-86</td>
<td>—</td>
<td>119\textsuperscript{c}</td>
<td>(119)\textsuperscript{c}</td>
<td>60,000\textsuperscript{b}</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$579,173</td>
<td>$189,173</td>
<td>$390,000</td>
<td>$ 60,000</td>
</tr>
</tbody>
</table>

\textsuperscript{a} Net investment equals cost less investment tax credit ($500,000 - $50,000).

\textsuperscript{b} Residual value that remains in the asset account at expiration of the lease.

\textsuperscript{c} Adjustment for fractional differences.

\textsuperscript{d} Present value of lease payments ($422,880) plus present value of the residual value ($27,120) = $450,000.

\textsuperscript{e} Includes unearned interest income of $6,416.

\textsuperscript{f} Net of unearned interest income of $6,416.

---

E. Intangibles and Other Assets

1N82
Answer 5

Part a.

1. \textit{Tully Corporation}

\textbf{INTANGIBLES SECTION OF BALANCE SHEET}

\textit{December 31, 1981}

Franchise from Rapid Copy Service, Inc., net of accumulated amortization of $6,870 (Schedule 1) $ 61,830

Patent, net of accumulated amortization of $2,050 (Schedule 2) 14,350

Trademark, net of accumulated amortization of $7,294 (Schedule 3) 42,706

Total intangibles $118,886

---

\textit{Schedule 1}

\textit{Computation of Franchise From Rapid Copy Service, Inc.}

Cost of franchise at January 1, 1981
Down payment $ 25,000
Present value of installments 43,700
Initial amount capitalized 68,700
Amortization of franchise for 1981 (68,700 ÷ 10 years) (6,870)
Franchise balance, December 31, 1981 $ 61,830

---

AP-215
Schedule 2

**Computation of Patent**

Capitalized cost of patent at January 2, 1981—legal fees and other costs associated with registration $16,400
Amortization of patent for 1981 ($16,400 ÷ 8 years) (2,050)
Patent balance, December 31, 1981 $14,350

Schedule 3

**Computation of Trademark**

<table>
<thead>
<tr>
<th>Cost</th>
<th>Accumulated Amortization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of trademark at July 1, 1978</td>
<td>$40,000</td>
</tr>
<tr>
<td>Amortization through December 31, 1980 ($40,000 ÷ 20 years = $2,000 × 2½ years)</td>
<td>$5,000</td>
</tr>
<tr>
<td>Amortization for period January 1–June 30, 1981 ($2,000 × ½)</td>
<td>1,000</td>
</tr>
<tr>
<td>Cost of successful litigation in defense of trademark, July 1, 1981</td>
<td>10,000</td>
</tr>
<tr>
<td>Balance, July 1, 1981</td>
<td>50,000</td>
</tr>
<tr>
<td>Amortization for period July 1–December 31, 1981 ($50,000 – $6,000 = $44,000 trademark balance ÷ 17 year remaining life = $2,588 × ½)</td>
<td>1,294</td>
</tr>
<tr>
<td>Balance, December 31, 1981</td>
<td>50,000</td>
</tr>
<tr>
<td>Deduct accumulated amortization</td>
<td>$7,294</td>
</tr>
<tr>
<td>Trademark balance, December 31, 1981</td>
<td>$42,706</td>
</tr>
</tbody>
</table>

2. **Tully Company**

**EXPENSES RESULTING FROM INTANGIBLES TRANSACTIONS**

For the Year Ended December 31, 1981

Franchise from Rapid Copy Service, Inc.
Amortization of franchise (Schedule 1) $6,870
Franchise fee on revenues from operations ($900,000 × 5%) 45,000
Imputed interest expense on unpaid balance of initial franchise fee ($43,700 × 14%) 6,118
Amortization of patent (Schedule 2) 57,988
Amortization of trademark ($1,000 + $1,294) (Schedule 3) 2,294
Total expenses $62,332
III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

1N84
Answer 4 (10 points)

a. 

Bristol Corporation
LONG-TERM LIABILITIES SECTION
OF BALANCE SHEET
December 31, 1983

15% note payable, bank, due in annual installments of $700,000, less current installment $1,400,000 [1]

Liability under capital lease, net present value of lease payments, less current installment 344,828 [2]

10% bonds payable due July 1, 1993, less unamortized discount of $219,560 at effective interest rate of 12% at date of issue 1,780,440 [3]

Deferred income taxes 396,000 [4]

Total long-term liabilities $3,921,268

b. 

Bristol Corporation
SELECTED BALANCE SHEET BALANCES
December 31, 1983

Current portion of long-term liabilities
Note payable, bank $700,000 [1]
Liability under capital lease 45,372 [2]
Total $745,372

Accrued interest payable
Note payable, bank $236,250 [5]
Bonds payable 100,000 [3]
Total $336,250

c. 

Bristol Corporation
INTEREST EXPENSE FROM LONG-TERM LIABILITIES AND DEFERRED INCOME TAX EXPENSE
For the Year Ended December 31, 1983

Interest expense
Note payable, bank $341,250 [6]
Liability under capital lease 60,200 [2]
Bonds payable 106,440 [3]
Total $507,890

Deferred income tax expense $36,000 [4]
### Explanations of Amounts

**[1]** 15% Note payable, Bank  
- Note payable, 12/31/82: $2,800,000  
- Deduct installment paid 4/1/83: 700,000  
- Balance, 12/31/83: 2,100,000  
- Deduct current installment due 4/1/84: 700,000  
- Long-term portion, 12/31/83: $1,400,000

**[2]** Liability under capital lease  
- Liability under capital lease, 12/31/82: $430,000  
- Deduct principal portion of 12/31/83 payment: 
  - Lease payment: $100,000  
  - Less imputed interest ($430,000 × 14%): 60,200  
  - Balance, 12/31/83: 390,200  
- Deduct current principal payment due 12/31/84: 
  - Lease payment: 100,000  
  - Less imputed interest ($390,200 × 14%): 54,628  
  - Balance, 12/31/83: $344,828

**[3]** Bonds payable  
- Bonds payable issued 7/1/83: $1,774,000  
- Add amortization of bond discount: 
  - Effective interest ($1,774,000 × 12% × 6/12): 106,440  
  - Less accrued interest payable 12/31/83: 
    - ($2,000,000 × 10% × 6/12): 100,000  
    - Balance, 12/31/83: $1,780,440

**[4]** Deferred income taxes  
- Deferred income taxes, 12/31/82: $360,000  
- Add timing difference — excess of tax depreciation over book depreciation of $90,000 × 40%: 36,000  
- Balance, 12/31/83: $396,000

**[5]** Accrued interest on note payable, bank  
- 4/1/83 to 12/31/83 ($2,100,000 × 15% × 9/12): $236,250

**[6]** Interest expense on note payable, bank  
- 1/1/83 to 3/31/83 ($2,800,000 × 15% × 3/12): $105,000  
- 4/1/83 to 12/31/83 ($2,100,000 × 15% × 9/12): 236,250  
- Interest, year ended 12/31/83: $341,250

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AP-218
1M82
Answer 4

Part b.

Greenlaw, Inc.
JOURNAL ENTRY—SITUATION 1
December 31, 1981

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Magazine subscriptions collected in advance</td>
<td>$500,000</td>
</tr>
<tr>
<td>Magazine subscriptions revenue</td>
<td>$500,000</td>
</tr>
<tr>
<td>To record subscriptions earned during 1981</td>
<td></td>
</tr>
<tr>
<td>Liability account</td>
<td></td>
</tr>
<tr>
<td>Book balance at December 31, 1981</td>
<td>2,400,000</td>
</tr>
<tr>
<td>Adjusted balance</td>
<td></td>
</tr>
<tr>
<td>($600,000 + $900,000 + $400,000)</td>
<td>1,900,000</td>
</tr>
<tr>
<td>Credit to revenue account</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

Greenlaw, Inc.
SITUATION 2
December 31, 1981

No entry should be made to accrue for an expense, because the absence of insurance coverage does not mean that an asset has been impaired or a liability has been incurred as of the balance sheet date. Greenlaw may, however, appropriate retained earnings for self-insurance as long as actual costs or losses are not charged to the appropriation of retained earnings and no part of appropriation is transferred to income. The loss contingency may also be disclosed in the notes to the financial statements. Appropriation of retained earnings and/or disclosure in the notes to the financial statements are not required.

Greenlaw, Inc.
JOURNAL ENTRY—SITUATION 3
December 31, 1981

Estimated loss from pending lawsuit | $100,000 |
Estimated liability from pending lawsuit | $100,000 |
To record estimated minimum damages on breach-of-contract litigation |        |
Accounting Practice

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

2M84
Answer 4

Part b.

Chee Corporation
STOCKHOLDERS’ EQUITY
December 31, 1983

Capital stock
Preferred stock, $4 cumulative, par value $50 per share;
authorized 50,000 shares, issued and outstanding 10,000 shares $ 500,000
Common stock, par value $1 per share;
authorized 500,000 shares, issued 150,000 shares, and outstanding 140,000 shares 150,000
Total capital stock 650,000
Additional paid-in capital — common
In excess of par value 1,560,000
From sale of treasury stock 250,000
Total paid-in capital 2,460,000
Retained earnings 231,000
Net unrealized loss on long-term equity securities ( 25,000)
Total paid-in capital and retained earnings 2,666,000
Less treasury stock, 10,000 shares at cost (180,000)
Total stockholders’ equity $2,486,000

E. Stock Options, Warrants, and Rights

1N81
Answer 5

Part a.

Holt, Inc.
JOURNAL ENTRY (1)
January 1, 1978

Debit Credit
 Deferred compensation cost $160,000
 Common stock options $160,000
 To record compensatory stock options at grant date:
 Compensation per share ($33 — $25) $8
 Stock option shares $20,000
 Common stock options and deferred compensation cost $160,000

Holt, Inc.
JOURNAL ENTRY (2)
December 31, 1978

Debit Credit
 Compensation expense $80,000
 Deferred compensation cost ($160,000 ÷ 2) $80,000
 To record compensation expense for 1978, based on write-off of deferred compensation cost
 over the stipulated two-year period of service

AP-220
Holt, Inc.

JOURNAL ENTRY (3)
April 1, 1979

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock options</td>
<td>$16,000</td>
</tr>
<tr>
<td>Deferred compensation</td>
<td>$8,000</td>
</tr>
<tr>
<td>Compensation expense</td>
<td>8,000</td>
</tr>
</tbody>
</table>

To record termination of 2,000 option shares held by employees at date they resigned their positions:

- Option shares terminated: 2,000
- Compensation per share: $8
- Common stock options and deferred compensation: $16,000
- Expensed year ended December 31, 1978 ($16,000 ÷ 2): 8,000
- Deferred compensation cost at April 1, 1979: $8,000

Holt, Inc.

JOURNAL ENTRY (4)
December 31, 1979

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation expense</td>
<td>$72,000</td>
</tr>
<tr>
<td>Deferred compensation cost ($160,000 - $80,000 - $8,000)</td>
<td>$72,000</td>
</tr>
</tbody>
</table>

To record compensation expense for 1979 and write-off of remaining deferred compensation cost.

Holt, Inc.

JOURNAL ENTRY (5)
March 31, 1980

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (12,000 × $25)</td>
<td>$300,000</td>
</tr>
<tr>
<td>Common stock options (12,000 × $8)</td>
<td>96,000</td>
</tr>
<tr>
<td>Common stock (12,000 × $10)</td>
<td>$120,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>276,000</td>
</tr>
</tbody>
</table>

To record issuance of 12,000 shares of $10 par common stock in exchange for 12,000 stock options and cash of $25 per share.

Holt, Inc.

December 31, 1980
(Not Required)

No entry for compensation expense for the stock options is required for year ended December 31, 1980, because the deferred compensation cost was properly expensed during 1978 and 1979.
G. Partnerships

1M82
Answer 4

Part a.

Allen, Brown, and Cox Partnership

COMPUTATION OF SAFE INSTALLMENT PAYMENTS TO PARTNERS
January 31, 1982

<table>
<thead>
<tr>
<th>Residual equities</th>
<th>Total</th>
<th>Allen</th>
<th>Brown</th>
<th>Cox</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit and loss ratio</td>
<td>100%</td>
<td>50%</td>
<td>30%</td>
<td>20%</td>
</tr>
<tr>
<td>Computation of January installment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preliquidation balances</td>
<td>$282,000</td>
<td>$118,000</td>
<td>$90,000</td>
<td>$74,000</td>
</tr>
<tr>
<td>Add (deduct) loans</td>
<td>(10,000)</td>
<td>(30,000)</td>
<td>20,000</td>
<td>—</td>
</tr>
<tr>
<td>Deduct January losses (Schedule 1)</td>
<td>(28,000)</td>
<td>(14,000)</td>
<td>(8,400)</td>
<td>(5,600)</td>
</tr>
<tr>
<td>Predistribution balances</td>
<td>244,000</td>
<td>74,000</td>
<td>101,600</td>
<td>68,400</td>
</tr>
<tr>
<td>Deduct potential losses (Schedule 1)</td>
<td>(199,000)</td>
<td>(99,500)</td>
<td>(59,700)</td>
<td>(39,800)</td>
</tr>
<tr>
<td>Deduct potential loss—Allen’s debit balance (Brown 3/5; Cox 2/5)</td>
<td>—</td>
<td>25,500</td>
<td>(15,300)</td>
<td>(10,200)</td>
</tr>
<tr>
<td>Safe payments to partners</td>
<td>$45,000</td>
<td>$0</td>
<td>$26,600</td>
<td>$18,400</td>
</tr>
</tbody>
</table>

Schedule 1

Computation of Actual and Potential

Liquidation Losses

January 1982

<table>
<thead>
<tr>
<th>Actual losses</th>
<th>Potential losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collection of accounts receivable ($66,000 – $51,000)</td>
<td>$15,000</td>
</tr>
<tr>
<td>Sale of inventory ($52,000 – $38,000)</td>
<td>14,000</td>
</tr>
<tr>
<td>Liquidation expenses</td>
<td>2,000</td>
</tr>
<tr>
<td>Gain resulting from January credit memorandum offset against payments to creditors</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Machinery and equipment, net</td>
<td>$189,000</td>
</tr>
<tr>
<td>Potential unrecorded liabilities and anticipated expenses</td>
<td>10,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$28,000</td>
</tr>
</tbody>
</table>
Unofficial Answers

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

1M82
Answer 5

Part a.

1. Hobson, Inc.

APPLICATION OF CASH RECEIPTS FROM SALE OF IDLE PLANT FACILITY TO COST RECOVERY, DEFERRED INCOME, AND INCOME RECOGNIZED UNDER THE COST RECOVERY METHOD OF ACCOUNTING

For the Period January 1, 1977, to February 1, 1981

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash received</th>
<th>Note receivable</th>
<th>Idle plant (net)</th>
<th>Deferred income</th>
<th>Income recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 1977</td>
<td>$100,000</td>
<td>$600,000</td>
<td>$(500,000)</td>
<td>$(200,000)</td>
<td></td>
</tr>
<tr>
<td>July 1, 1978</td>
<td>190,000</td>
<td>(100,000)</td>
<td></td>
<td>(90,000)</td>
<td></td>
</tr>
<tr>
<td>December 31, 1979</td>
<td>275,000</td>
<td>(200,000)</td>
<td></td>
<td>(10,000)</td>
<td>$(65,000)*</td>
</tr>
<tr>
<td>February 1, 1981</td>
<td>332,500</td>
<td>(300,000)</td>
<td></td>
<td></td>
<td>(32,500)</td>
</tr>
<tr>
<td>February 1, 1981</td>
<td></td>
<td></td>
<td></td>
<td>300,000</td>
<td>(300,000)</td>
</tr>
</tbody>
</table>

* Total cash received $565,000 ($100,000 + $190,000 + $275,000)
Idle plant (net) $500,000
Income recognized $65,000

2. Hobson, Inc.

JOURNAL ENTRY
April 1, 1981

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
</table>
Machinery and Equipment | $220,000            |
($190,000 + $30,000)    |                    |
Land                   | $105,000            |
Gain on disposal of land| 85,000              |
($190,000 - $105,000)   |                    |
Cash                   | 30,000              |
To record the exchange of land for a used printing press of Tyler Company

AP-223
B. Expenses and Losses

1M82
Answer 5

Part b.

Foster Corporation

COMPUTATION OF PENSION EXPENSE REPORTED ON THE INCOME STATEMENTS
For the Years Ended December 31, 1980, and 1981

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal cost</td>
<td>$60,000</td>
<td>$65,000</td>
</tr>
<tr>
<td>Past service cost</td>
<td>29,685</td>
<td>29,685</td>
</tr>
<tr>
<td>Interest on liability for pension expense not funded at December 31, 1980 ($3,530 \times 6%)</td>
<td>—</td>
<td>212</td>
</tr>
<tr>
<td>Total pension expense</td>
<td>$89,685</td>
<td>$94,897</td>
</tr>
</tbody>
</table>

Foster Corporation

COMPUTATION OF LIABILITY FOR PENSION EXPENSE NOT FUNDED REPORTED ON THE BALANCE SHEETS
As of December 31, 1980, and 1981

Past service cost amortization—1980                      $29,685
Deduct past service cost funded—December 31, 1980        26,155
Liability for pension expense not funded—balance at December 31, 1980 3,530
Add interest on liability for pension expense not funded at December 31, 1980 ($3,530 \times 6\%) | 212   |
Past service cost amortization—1981                      29,685
Deduct past service cost funded—December 31, 1981        33,427
Liability for pension expense not funded—balance at December 31, 1981 $ 7,272

2. Foster Corporation

COMPUTATION OF MINIMUM PENSION PROVISION
For the Year Ended December 31, 1980

Normal cost $60,000
Interest on unfunded past service cost ($300,000 \times 6\%) 18,000
Minimum pension provision $78,000

Foster Corporation

COMPUTATION OF MAXIMUM PENSION PROVISION
For the Year Ended December 31, 1980

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal cost</td>
<td>$60,000</td>
</tr>
<tr>
<td>Past service cost amortization ($300,000 \times 10%)</td>
<td>30,000</td>
</tr>
<tr>
<td>Maximum pension provision</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

1M81
Answer 5

Part a.

Sutter Company

COMPUTATION OF EXPENSE ON OPERATING LEASE
For the Year Ended December 31, 1980

Rental expense ($18,000 \times 10 months) $180,000
DeductDepreciation ($1,200,000 \div 10 \times 10/12) $100,000
Amortization of commission for negotiating lease ($60,000 \times 10/48) 12,500
Income from operating lease $ 67,500

2. Riley, Inc.

COMPUTATION OF INCOME BEFORE INCOME TAXES ON OPERATING LEASE
For the Year Ended December 31, 1980

Rental income ($18,000 \times 10 months) $180,000
DeductDepreciation ($1,200,000 \div 10 \times 10/12) $100,000
Amortization of commission for negotiating lease ($60,000 \times 10/48) 12,500
Income from operating lease $ 67,500
C. Provision for Income Tax

2N82
Answer 4 (10 points)

1. **Howe Corporation**

**COMPUTATION OF NET DEDUCTIONS FOR TAX REPORTING PURPOSES**
**GIVING RISE TO INTERPERIOD TAX ALLOCATION ON ORDINARY INCOME**

*For the Years Ended December 31,*

<table>
<thead>
<tr>
<th></th>
<th>1979</th>
<th>1980</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation—packaging equipment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(($450,000 - $60,000) \times \frac{5}{15})</td>
<td>$130,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(($450,000 - $60,000) \times \frac{4}{15})</td>
<td>$104,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(($450,000 - $60,000) \times \frac{3}{15})</td>
<td></td>
<td>$78,000</td>
<td></td>
</tr>
<tr>
<td>Patent amortization (($68,000 \div 17))</td>
<td></td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td>Total deductions</td>
<td>130,000</td>
<td>104,000</td>
<td>82,000</td>
</tr>
<tr>
<td>Less rental income</td>
<td>120,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net deductions for income tax reporting</strong></td>
<td><strong>$130,000</strong></td>
<td><strong>$(16,000)</strong></td>
<td><strong>$82,000</strong></td>
</tr>
</tbody>
</table>

Note: Investment credit is ignored in computing interperiod tax allocation.

2. **Howe Corporation**

**COMPUTATION OF NET DEDUCTIONS FOR FINANCIAL STATEMENTS**
**ADJUSTED FOR PERMANENT DIFFERENCE GIVING RISE TO INTERPERIOD TAX ALLOCATION ON ORDINARY INCOME**

*For the Years Ended December 31,*

<table>
<thead>
<tr>
<th></th>
<th>1979</th>
<th>1980</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation—packaging equipment, based on cost less salvage value, before offset of investment credit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(($450,000 - $60,000) \div 5)</td>
<td>$78,000</td>
<td>$78,000</td>
<td>$78,000</td>
</tr>
<tr>
<td>Patent amortization (($68,000 \div 4))</td>
<td></td>
<td></td>
<td>17,000</td>
</tr>
<tr>
<td>Total deductions</td>
<td>78,000</td>
<td>78,000</td>
<td>95,000</td>
</tr>
<tr>
<td>Less rental income (($120,000 \div 3))</td>
<td></td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Net deductions for financial statements as adjusted</strong></td>
<td><strong>$78,000</strong></td>
<td><strong>$38,000</strong></td>
<td><strong>$55,000</strong></td>
</tr>
</tbody>
</table>

3. **Howe Corporation**

**COMPUTATION OF DEFERRED TAX CREDIT**
**AT CAPITAL GAINS RATE**

*At December 31, 1981*

- Gain on sale of land for financial reporting purposes \((\$400,000 - \$300,000)\) | $100,000 |
- Gain on sale of land for tax reporting purposes \((\$400,000 - \$300,000) \div 10\) | 10,000  |
- Deferred gain for tax reporting purposes | 90,000  |
- Capital gains rate \(\times 28\%) |        |
- **Deferred tax credit at capital gains rate** | **$25,200** |

AP-225
4. Howe Corporation

COMPUTATION OF TOTAL NET DEFERRED TAX CREDITS (DEBITS)
At December 31,

<table>
<thead>
<tr>
<th></th>
<th>1979</th>
<th>1980</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timing differences taxed at ordinary rates:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net deductions for income tax purposes</td>
<td>$130,000</td>
<td>$(16,000)</td>
<td>$82,000</td>
</tr>
<tr>
<td>Net deductions for financial statement purposes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>as adjusted</td>
<td>78,000</td>
<td>38,000</td>
<td>55,000</td>
</tr>
<tr>
<td>Tax deductions in excess of financial statement</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>deductions</td>
<td>52,000</td>
<td>(54,000)</td>
<td>27,000</td>
</tr>
<tr>
<td>Tax rate on ordinary income</td>
<td>×40%</td>
<td>×40%</td>
<td>×40%</td>
</tr>
<tr>
<td>Deferred tax credits (debit) at ordinary rates</td>
<td>20,800</td>
<td>(21,600)</td>
<td>10,800</td>
</tr>
<tr>
<td>Deferred tax credit at 28% capital gains rate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total net deferred tax credits (debit)</td>
<td>20,800</td>
<td>(21,600)</td>
<td>36,000</td>
</tr>
<tr>
<td>Cumulative total deferred tax credits</td>
<td>$28,000</td>
<td>$(800)</td>
<td>$35,200</td>
</tr>
</tbody>
</table>

5. Howe Corporation

COMPUTATION OF TOTAL INCOME TAX EXPENSE
FOR FINANCIAL STATEMENT PURPOSES
For the Years Ended December 31

<table>
<thead>
<tr>
<th></th>
<th>1979</th>
<th>1980</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes per tax returns</td>
<td>$50,000</td>
<td>$142,400</td>
<td>$101,280</td>
</tr>
<tr>
<td>Add investment credit</td>
<td>30,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income taxes before investment credit</td>
<td>80,000</td>
<td>142,400</td>
<td>101,280</td>
</tr>
<tr>
<td>Add deferred tax credits (debit)</td>
<td>20,800</td>
<td>(21,600)</td>
<td>36,000</td>
</tr>
<tr>
<td>Total income tax expense before investment credit</td>
<td>100,800</td>
<td>120,800</td>
<td>137,280</td>
</tr>
<tr>
<td>Less amortization of investment credit</td>
<td>6,000</td>
<td>6,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Total income tax expense</td>
<td>$94,800</td>
<td>$114,800</td>
<td>$131,280</td>
</tr>
</tbody>
</table>
F. Earnings Per Share

1N81
Answer 5

Part b.

Mason Corporation

1. NUMBER OF SHARES FOR COMPUTATION OF

PRIMARY EARNINGS PER COMMON SHARE

For Year Ended December 31, 1980

<table>
<thead>
<tr>
<th>Shares</th>
<th>Weighted Average Number of Common Shares Outstanding—1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dates</td>
<td>Shares</td>
</tr>
<tr>
<td>January 1—August 31</td>
<td>300,000</td>
</tr>
<tr>
<td>September 1, sold additional shares</td>
<td>36,000</td>
</tr>
<tr>
<td>September 1—December 31</td>
<td>336,000</td>
</tr>
<tr>
<td>Total share—months</td>
<td>3,744,000</td>
</tr>
<tr>
<td>Weighted average number of shares outstanding</td>
<td>312,000</td>
</tr>
</tbody>
</table>

Schedule 2

Common Stock Equivalents From Stock Options—
Treasury Stock Method

<table>
<thead>
<tr>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares that would be issued upon exercise of options</td>
</tr>
<tr>
<td>Cash proceeds that would be realized upon exercise [30,000 shares \times$22.50 (option price) = $675,000]</td>
</tr>
<tr>
<td>Treasury shares that could be purchased [($760,000 \div $36 (average market price))]</td>
</tr>
<tr>
<td>Dilutive common stock equivalents</td>
</tr>
</tbody>
</table>

Schedule 3

Common Stock Equivalents From Warrants—
Treasury Stock Method

<table>
<thead>
<tr>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares that would be issued upon exercise of warrants</td>
</tr>
<tr>
<td>Cash proceeds that would be realized upon exercise [20,000 shares \times $38 (exercise price) = $760,000]</td>
</tr>
<tr>
<td>Treasury shares that could be purchased [($760,000 \div $36 (average market price)]*</td>
</tr>
<tr>
<td>Antidilutive common stock equivalents (not included in EPS computations)</td>
</tr>
</tbody>
</table>

* For purposes of computing fully diluted earnings per share, the $33 market price per share at December 31, 1980, is not used because it is lower than the $36 average market price for 1980.

2. Mason Corporation

COMPUTATION OF PRIMARY EARNINGS PER COMMON SHARE

For Year Ended December 31, 1980

Income:
Net income $750,000
Deduct dividends paid on preferred stock (10,000 shares \times $3) 30,000
Net income, adjusted $720,000
Number of shares (Part b. 1) 323,250
Primary earnings per share ($720,000 \div 323,250) $ 2.23

3. Mason Corporation

NUMBER OF SHARES FOR COMPUTATION OF FULLY DILUTED EARNINGS PER COMMON SHARE

For Year Ended December 31, 1980

Weighted average number of shares outstanding (Schedule 1) 312,000
Common stock equivalents
From stock options—dilutive (Schedule 2) 11,250
From warrants—antidilutive (Schedule 3) 0
Shares assumed to be issued upon conversion of convertible bonds ($1,000,000 \div $1,000 = 1,000 bonds \times 40) 40,000
Total number of shares for fully diluted EPS computation 363,250

* For purposes of computing fully diluted earnings per share, the $33 market price per share at December 31, 1980, is not used because it is lower than the $36 average market price for 1980.
Accounting Practice

1N81
Answer 5 (cont.)

4. Mason Corporation

COMPUTATION OF FULLY DILUTED EARNINGS PER COMMON SHARE
For Year Ended December 31, 1980

Income:
Net income $750,000
Deduct dividends paid on preferred stock
   (10,000 shares × $3) 30,000
   720,000

Add interest expense (net of income tax effect) on convertible bonds
   [$1,000,000 × 8% = $80,000 × .60 (1.00 − .40 tax rate)] 48,000

Net income, adjusted $768,000
Number of shares (Part b. 3) 363,250
Fully diluted earnings per share ($768,000 ÷ 363,250) $ 2.11

VII. Cost Accumulation, Planning, and Control

2M85
Answer 4 (10 points)

Mayne Manufacturing Co.
CASH BUDGET
For the Years Ending March 31,

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance of cash at beginning</td>
<td>$ 0</td>
<td>$ 75,000</td>
</tr>
<tr>
<td>Cash generated from operations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Collections from customers — Schedule A</td>
<td>$825,000</td>
<td>$1,065,000</td>
</tr>
<tr>
<td>Disbursements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct materials — Schedule B</td>
<td>220,000</td>
<td>245,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>300,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Variable overhead</td>
<td>100,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>130,000</td>
<td>130,000</td>
</tr>
<tr>
<td>Total disbursements</td>
<td>750,000</td>
<td>855,000</td>
</tr>
<tr>
<td>Excess of cash collections over cash disbursements from operations</td>
<td>75,000</td>
<td>210,000</td>
</tr>
<tr>
<td>Cash available from operations</td>
<td>75,000</td>
<td>285,000</td>
</tr>
<tr>
<td>Cash received from liquidation of existing accounts receivable and inventories</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Total cash available</td>
<td>165,000</td>
<td>285,000</td>
</tr>
<tr>
<td>Payments to general creditors</td>
<td>90,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Balance of cash at end</td>
<td>$ 75,000 [1]</td>
<td>$ 15,000 [1]</td>
</tr>
</tbody>
</table>

[1] This amount could have been used to pay general creditors or carried forward to the beginning of the next year.

[2] ($600,000 × 60%) − ($50,000 + $40,000)
Unofficial Answers

2M85
Answer 4 (cont.)

Schedule A
Mayne Manufacturing Co.
COLLECTIONS FROM CUSTOMERS
For the Years Ending March 31,

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$900,000</td>
<td>$1,080,000</td>
</tr>
<tr>
<td>Beginning accounts receivable</td>
<td>0</td>
<td>75,000</td>
</tr>
<tr>
<td>Total</td>
<td>900,000</td>
<td>1,155,000</td>
</tr>
<tr>
<td>Less ending accounts receivable</td>
<td>75,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Collections from customers</td>
<td>$825,000</td>
<td>$1,065,000</td>
</tr>
</tbody>
</table>

Schedule B
Mayne Manufacturing Co.
DISBURSEMENTS FOR DIRECT MATERIALS
For the Years Ending March 31,

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials required for production</td>
<td>$200,000</td>
<td>$240,000</td>
</tr>
<tr>
<td>Required ending inventory</td>
<td>40,000 [3]</td>
<td>50,000 [4]</td>
</tr>
<tr>
<td>Total</td>
<td>240,000</td>
<td>290,000</td>
</tr>
<tr>
<td>Less beginning inventory</td>
<td>0</td>
<td>40,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>240,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Beginning accounts payable</td>
<td>0</td>
<td>20,000</td>
</tr>
<tr>
<td>Total</td>
<td>240,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Less ending accounts payable</td>
<td>20,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Disbursements for direct materials</td>
<td>$220,000</td>
<td>$245,000</td>
</tr>
</tbody>
</table>

[3] 12,000 units × \(\frac{3}{12}\) = 2,000; 2,000 × $20 per unit = $40,000
[4] 15,000 units × \(\frac{3}{12}\) = 2,500; 2,500 × $20 per unit = $50,000

2N84
Answer 5 (10 points)

Poe Corp.
Boston Plant
COMPUTATION OF NUMBER OF UNITS OF XOFF REQUIRED TO COVER FIXED FACTORY OVERHEAD AND FIXED REGIONAL PROMOTIONAL COSTS

<table>
<thead>
<tr>
<th></th>
<th>Total (000 omitted)</th>
<th>Per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,200</td>
<td>$20</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>550</td>
<td>5</td>
</tr>
<tr>
<td>Direct labor</td>
<td>660</td>
<td>6</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>440</td>
<td>4</td>
</tr>
<tr>
<td>Total variable costs</td>
<td>1,650</td>
<td>15</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>$ 550</td>
<td>$ 5</td>
</tr>
</tbody>
</table>

Units required to cover fixed factory overhead and fixed regional promotional costs:

\[
\frac{($700,000 + $100,000)}{\$5} = 160,000 \text{ units of Xoff}
\]
Poe Corp.

1. SCHEDULE OF BUDGETED CONTRIBUTION MARGIN AND OPERATING INCOME IF BOSTON OPERATIONS ARE EXPANDED (PLAN A)
   For the Year Ending December 31, 1985

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$7,400</td>
<td>$3,400</td>
<td>$4,000</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>1,850</td>
<td>850</td>
<td>1,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>2,020</td>
<td>1,020</td>
<td>1,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>1,380</td>
<td>680</td>
<td>700</td>
</tr>
<tr>
<td>Total variable costs</td>
<td>5,250</td>
<td>2,550</td>
<td>2,700</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>2,150</td>
<td>850</td>
<td>1,300</td>
</tr>
<tr>
<td>Fixed costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>1,600</td>
<td>700</td>
<td>900</td>
</tr>
<tr>
<td>Regional promotional</td>
<td>320</td>
<td>220</td>
<td>100</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>1,920</td>
<td>920</td>
<td>1,000</td>
</tr>
<tr>
<td>Plant operating income (loss)</td>
<td>230</td>
<td>(70)</td>
<td>300</td>
</tr>
<tr>
<td>Allocated home office costs</td>
<td>310</td>
<td>142*</td>
<td>168**</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>$ (80)</td>
<td>$ (212)</td>
<td>$ 132</td>
</tr>
</tbody>
</table>

\[
\frac{\$3,400}{\$7,400} \times \$310 = \$142 \quad \text{or} \quad \frac{\$4,000}{\$7,400} \times \$310 = \$168
\]

2. SCHEDULE OF BUDGETED CONTRIBUTION MARGIN AND OPERATING INCOME IF BOSTON PLANT IS CLOSED AND CHICAGO OPERATIONS ARE EXPANDED (PLAN B)
   For the Year Ending December 31, 1985

<table>
<thead>
<tr>
<th></th>
<th>Chicago Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$6,200</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>1,550</td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,550</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>1,085</td>
</tr>
<tr>
<td>Total variable costs</td>
<td>4,185</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>2,015</td>
</tr>
<tr>
<td>Fixed costs</td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>950</td>
</tr>
<tr>
<td>Regional promotional</td>
<td>200</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>1,150</td>
</tr>
<tr>
<td>Plant operating income</td>
<td>865</td>
</tr>
<tr>
<td>Allocated home office costs</td>
<td>310</td>
</tr>
<tr>
<td>Operating income</td>
<td>$ 555</td>
</tr>
</tbody>
</table>
Unofficial Answers

2M84
Answer 5 (cont.)

Poe Corp.
SCHEDULE OF BUDGETED CONTRIBUTION MARGIN
AND OPERATING INCOME IF BOSTON PLANT IS CLOSED
AND ROYALTY AGREEMENT IS CONTRACTED (PLAN C)
For the Year Ending December 31, 1985

<table>
<thead>
<tr>
<th>Royalties (000 omitted)</th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$4,000</td>
<td>$4,000</td>
<td></td>
</tr>
<tr>
<td>Royalties</td>
<td>275</td>
<td>275</td>
<td></td>
</tr>
<tr>
<td>Total revenues</td>
<td>4,275</td>
<td>275</td>
<td>4,000</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>1,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>700</td>
<td>700</td>
<td></td>
</tr>
<tr>
<td>Total variable costs</td>
<td>2,700</td>
<td></td>
<td>2,700</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>1,575</td>
<td>275</td>
<td>1,300</td>
</tr>
<tr>
<td>Fixed costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>950</td>
<td>50</td>
<td>900</td>
</tr>
<tr>
<td>Regional promotional</td>
<td>200</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>1,150</td>
<td>150</td>
<td>1,000</td>
</tr>
<tr>
<td>Plant operating income and royalty</td>
<td>425</td>
<td>125</td>
<td>300</td>
</tr>
<tr>
<td>Allocated home office costs</td>
<td>310</td>
<td></td>
<td>310</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>$115</td>
<td>$125</td>
<td>$(10)</td>
</tr>
</tbody>
</table>

2M84
Answer 4

Part a.

Mat Company
SCHEDULE OF COST OF GOODS MANUFACTURED
For the Month Ended March 31, 1984

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work in process — beginning inventory</td>
<td>$40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct materials</td>
<td>$104,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct labor</td>
<td>160,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Factory overhead applied</td>
<td>80,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total production costs available</td>
<td>384,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less work in process — ending inventory</td>
<td>36,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods manufactured</td>
<td>$348,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Mat Company
SCHEDULE OF PRIME COST
For the Month Ended March 31, 1984

<table>
<thead>
<tr>
<th>Direct materials</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning inventory</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>110,000</td>
</tr>
<tr>
<td>Direct materials available</td>
<td>130,000</td>
</tr>
<tr>
<td>Less ending inventory</td>
<td>26,000</td>
</tr>
<tr>
<td>Direct materials used</td>
<td>104,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>160,000</td>
</tr>
<tr>
<td>Total prime cost</td>
<td>$264,000</td>
</tr>
</tbody>
</table>

3. Mat Company
SCHEDULE OF CONVERSION COST
For the Month Ended March 31, 1984

<table>
<thead>
<tr>
<th>Direct labor</th>
<th>$160,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factory overhead applied (50% of direct labor)</td>
<td>80,000</td>
</tr>
<tr>
<td>Total conversion cost</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

AP-231
Beal Company
SCHEDULE OF BUDGETED PRODUCTION COSTS
BASED ON 7,800 UNITS
For the Month Ended January 31, 1984

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>7,800 units \times 3 lbs. \times $2.50 = $58,500</td>
</tr>
<tr>
<td>Direct labor</td>
<td>7,800 units \times 5 hrs. \times $7.50 = 292,500</td>
</tr>
<tr>
<td>Factory overhead</td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>7,800 units \times 5 hrs. \times $3.00 = 117,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>40,000 hrs. \times $4.00 = 160,000</td>
</tr>
<tr>
<td><strong>Total budgeted production costs</strong></td>
<td><strong>$628,000</strong></td>
</tr>
</tbody>
</table>

b.
1. Direct materials price variance based on materials purchased
   \((2.60 - 2.50) \times 25,000 lbs.) = 2,500 unfavorable
2. Direct materials usage variance
   \([23,100 lbs. - (7,800 units \times 3 hrs.)] \times $2.50 = 750 favorable
3. Direct labor rate variance
   \((7.30 - 7.50) \times 40,100 hrs.) = 8,020 favorable
4. Direct labor efficiency variance
   \([40,100 hrs. - (7,800 units \times 5 hrs.)] \times $7.50 = 8,250 unfavorable
5. Factory overhead spending variance
   Actual total factory overhead = $300,000
   Budgeted total factory overhead at actual hours
   \((40,100 \times $3.00) + (40,000 \times $4.00) = 280,300
   Factory overhead spending variance = 19,700 unfavorable
6. Variable factory overhead efficiency variance
   Budgeted total factory overhead at actual hours = $280,300
   Budgeted total factory overhead at standard hours
   \((117,000 + 160,000) = 277,000
   Variable factory overhead efficiency variance = 3,300 unfavorable
7. Factory overhead volume variance
   Budgeted total factory overhead at standard hours = 277,000
   Applied total factory overhead \((7,800 \times 5 hrs. \times $7.00) = 273,000
   Factory overhead volume variance = 4,000 unfavorable
a. The breakeven point in patient days equals total fixed cost divided by contribution margin per patient day.

**Pediatrics**

**COMPUTATION OF BREAK-EVEN POINT IN PATIENT DAYS**

*For the Year Ending June 30, 1983*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total fixed costs <em>(Schedule 1)</em></td>
<td>$3,380,000</td>
</tr>
<tr>
<td>Divided by contribution margin per patient day <em>(Schedule 2)</em></td>
<td>$200</td>
</tr>
<tr>
<td>Breakeven point in patient days</td>
<td>16,900</td>
</tr>
</tbody>
</table>

**Schedule 1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Melford Hospital charges</td>
<td>$2,900,000</td>
</tr>
<tr>
<td>Supervising nurses</td>
<td>$100,000</td>
</tr>
<tr>
<td>Nurses</td>
<td>$200,000</td>
</tr>
<tr>
<td>Aides</td>
<td>$180,000</td>
</tr>
<tr>
<td><strong>Total fixed costs</strong></td>
<td><strong>$3,380,000</strong></td>
</tr>
</tbody>
</table>

**Schedule 2**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue per patient day</td>
<td>$300</td>
</tr>
<tr>
<td>Variable costs per patient day</td>
<td></td>
</tr>
<tr>
<td>($6,000,000 ÷ $300 = 20,000 patient days)</td>
<td>100</td>
</tr>
<tr>
<td>($2,000,000 ÷ 20,000 patient days)</td>
<td></td>
</tr>
<tr>
<td><strong>Contribution margin per patient day</strong></td>
<td><strong>$200</strong></td>
</tr>
</tbody>
</table>

b. **Pediatrics**

**COMPUTATION OF LOSS FROM RENTAL OF ADDITIONAL 20 BEDS**

*For the Year Ending June 30, 1983*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in revenue <em>(20 additional beds × 90 days × $300 charge per day)</em></td>
<td>$540,000</td>
</tr>
<tr>
<td>Increase in expenses</td>
<td></td>
</tr>
<tr>
<td>Variable charges by Melford Hospital</td>
<td>180,000</td>
</tr>
<tr>
<td><em>(20 additional beds × 90 days × $100 per day)</em></td>
<td></td>
</tr>
<tr>
<td>Fixed charges by Melford Hospital</td>
<td>966,667</td>
</tr>
<tr>
<td><em>(2,900,000 ÷ 60 beds = $48,333 per bed × 20 beds)</em></td>
<td></td>
</tr>
<tr>
<td>or <em>[2,900,000 × (20 ÷ 60)]</em></td>
<td></td>
</tr>
<tr>
<td>Salaries expense <strong>(20,000 patient days before additional 20 beds, + 20 additional beds × 90 days = 21,800, which does not exceed 21,900 patient days; therefore, no additional personnel are required)</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Total increase in expenses</strong></td>
<td>1,146,667</td>
</tr>
<tr>
<td>Net decrease in earnings from rental of additional 20 beds</td>
<td>$606,667</td>
</tr>
</tbody>
</table>
2M82
Answer 5 (10 points)

Part a.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. By-product inventory—Nagu</td>
<td>$3,000</td>
</tr>
<tr>
<td>Work in process—Rey</td>
<td>$3,000</td>
</tr>
<tr>
<td>(30,000 lbs. @ $.10/lb.)</td>
<td></td>
</tr>
<tr>
<td>2. By-product inventory—Nagu</td>
<td>9,000</td>
</tr>
<tr>
<td>Raw materials</td>
<td>2,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,500</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>500</td>
</tr>
<tr>
<td>Work in process—Rey</td>
<td>5,000</td>
</tr>
<tr>
<td>(30,000 lbs. @ $.30/lb.)</td>
<td></td>
</tr>
<tr>
<td>3. Work in process—Nagu</td>
<td>4,500*</td>
</tr>
<tr>
<td>Work in process—Rey</td>
<td>4,500</td>
</tr>
<tr>
<td>Work in process—Nagu</td>
<td>4,000</td>
</tr>
<tr>
<td>Raw materials</td>
<td>2,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,500</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>500</td>
</tr>
<tr>
<td>Finished goods—Nagu</td>
<td>8,500</td>
</tr>
<tr>
<td>Work in process—Nagu</td>
<td>8,500</td>
</tr>
</tbody>
</table>

* 30,000 lbs. × $.10
394,000 lbs. × $.50 + 30,000 lbs. × $.10 × $300,000

Part b.

1. **Montero Corporation**
   
   **EXPECTED CASH COLLECTIONS**
   
   **May 1982**
   
<table>
<thead>
<tr>
<th>Month</th>
<th>Sales</th>
<th>Percent</th>
<th>Expected collections</th>
</tr>
</thead>
<tbody>
<tr>
<td>March</td>
<td>$60,000</td>
<td>9</td>
<td>$5,400</td>
</tr>
<tr>
<td>April</td>
<td>78,000</td>
<td>20</td>
<td>15,600</td>
</tr>
<tr>
<td>May</td>
<td>66,000</td>
<td>70</td>
<td>46,200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>$67,200</strong></td>
</tr>
</tbody>
</table>

2. **Montero Corporation**
   
   **EXPECTED CASH DISBURSEMENTS**
   
   **May 1982**
   
   April purchases to be paid in May | $54,000 |
   Less: 2% cash discount | 1,080 |
   Net | $52,920 |
   Cash disbursements for expenses | 14,400 |
   **Total** | **$67,320** |

3. **Montero Corporation**
   
   **EXPECTED CASH BALANCE**
   
   **May 31, 1982**
   
   Balance, May 1 | $22,000 |
   Expected collections | $67,200 |
   Expected disbursements | 67,320 (120) |
   **Expected balance** | **$21,880** |

2N81
Answer 4 (10 points)

a. **Armando Corporation**

**COMPUTATION OF VARIABLE AND FIXED FACTORY OVERHEAD PER UNIT**

Factory overhead per unit
- Variable ($30 × 2/3) | $20.00 |
- Fixed ($30 × 1/3) | 10.00 |
- **Total** | **$30.00** |

**Schedule 1**

**Computation of Variable Factory Overhead Rate Per Direct Labor Hour**

Variable factory overhead per unit | $20.00 |
Direct labor hours per unit | 4 | $5.00 |

**Schedule 2**

**Computation of Total Fixed Factory Overhead**

Direct labor hours (2,400) × Fixed factory overhead rate per direct labor hour ($10.00 ÷ 4 hours) | $6,000 |

b. **COMPUTATION OF VARIANCES**

**Month Ended July 31, 1981**

**Schedule 1**

**Materials Price Variance**
Based on Purchases
- Direct materials actually purchased (18,000 × $1.38) | $24,840 |
- Standard cost of above (18,000 × $1.35) | 24,300 |
- Materials price variance—unfavorable | **$540** |

**Schedule 2**

**Materials Usage Variance**
- Actual quantity used at standard cost (9,500 × $1.35) | $12,825 |
- Standard quantity allowed (500 units × 20 yards) at standard cost (10,000 × $1.35) | 13,500 |
- Materials usage variance—favorable | **$675** |

**Schedule 3**

**Labor Rate Variance**
- Actual hours at actual rate (2,100 × $9.15) | $19,215 |
- Actual hours at standard rate (2,100 × $9.00) | 18,900 |
- Labor rate variance—unfavorable | **$315**
2N81
Answer 4 (cont.)

Schedule 4  
**Labor Efficiency Variance**
- Actual hours at standard rate (2,100 × $9.00) = $18,900
- Standard hours allowed (500 units × 4) at standard rate (2,000 × $9.00) = 18,000
- Labor efficiency variance—unfavorable = $900

Schedule 5  
**Controllable Factory Overhead Variance**
- Actual total factory overhead = $16,650
- Budgeted factory overhead at standard hours:
  - Fixed = $6,000
  - Variable (500 units × 4 hours × $5.00) = 10,000
  - Total controllable factory overhead variance—unfavorable = $650

Schedule 6  
**Capacity (Volume) Factory Overhead Variance**
- Budgeted factory overhead at standard hours = $16,000
- Applied total factory overhead:
  - Hours allowed—2,000 × $7.50 (5/6 × $9.00) = 15,000
- Capacity factory overhead variance—unfavorable = $1,000

c.  
**Vogue Fashions, Inc.**  
**MATERIALS AND LABOR VARIANCES**  
*For the Month Ended June 30, 1980*

<table>
<thead>
<tr>
<th>Lot no.</th>
<th>22</th>
<th>23</th>
<th>24</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials quantity variance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard yards per lot</td>
<td>1,000</td>
<td>1,700</td>
<td>1,200</td>
</tr>
<tr>
<td>Total standard quantity</td>
<td>24,000</td>
<td>40,800</td>
<td>28,800</td>
</tr>
<tr>
<td>Actual yards used</td>
<td>24,100</td>
<td>40,440</td>
<td>28,825</td>
</tr>
<tr>
<td>Variance in yards</td>
<td>100</td>
<td>(360)</td>
<td>25</td>
</tr>
<tr>
<td>Labor efficiency variance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard hours per lot</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Total percentage of completion</td>
<td>100</td>
<td>100</td>
<td>80</td>
</tr>
<tr>
<td>Total standard hours</td>
<td>3,000</td>
<td>5,100</td>
<td>2,880</td>
</tr>
<tr>
<td>Actual hours worked</td>
<td>2,980</td>
<td>5,130</td>
<td>2,890</td>
</tr>
<tr>
<td>Variance in hours</td>
<td>(20)</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>Labor rate variance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual hours worked</td>
<td>2,980</td>
<td>5,130</td>
<td>2,890</td>
</tr>
<tr>
<td>Rate paid in excess of standard</td>
<td>($5.00 - 4.90)</td>
<td>.10</td>
<td>.10</td>
</tr>
<tr>
<td>Variance</td>
<td>$298</td>
<td>$513</td>
<td>$289</td>
</tr>
</tbody>
</table>

\(\text{( ) Indicates favorable variance}\)

2M81  
Answer 5 (10 points)

**Vogue Fashions, Inc.**  
**STANDARD COST OF PRODUCTION**  
*For the Month Ended June 30, 1980*

<table>
<thead>
<tr>
<th>Lot</th>
<th>Quantity (dozens)</th>
<th>Standard cost per dozen</th>
<th>Total standard cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>1,000</td>
<td>$53.10</td>
<td>$53,100</td>
</tr>
<tr>
<td>23</td>
<td>1,700</td>
<td>53.10</td>
<td>90,270</td>
</tr>
<tr>
<td>24</td>
<td>1,200</td>
<td>47.76*</td>
<td>57,312</td>
</tr>
</tbody>
</table>

Standard cost of production = $200,682

\(\text{*( Standard material cost plus 80% of standard cost of labor and overhead } [26.40 + (.80 \times 26.70)]\)
d. Vogue Fashions, Inc.
MANUFACTURING OVERHEAD VARIANCES
For the Month Ended June 30, 1980

Controllable variance

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual manufacturing overhead</td>
<td>$45,600</td>
</tr>
<tr>
<td>Budgeted for level of production attained</td>
<td></td>
</tr>
<tr>
<td>Fixed (0.40 x $576,000/12)</td>
<td>$19,200</td>
</tr>
<tr>
<td>Variable ($4.00 x 0.60 x 10,980 standard hours)</td>
<td>26,352</td>
</tr>
<tr>
<td>Total budgeted</td>
<td>45,552</td>
</tr>
<tr>
<td>Unfavorable controllable variance</td>
<td>$ 48</td>
</tr>
</tbody>
</table>

Noncontrollable variance

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budgeted for level of production attained</td>
<td>$45,552</td>
</tr>
<tr>
<td>Overhead applied to production</td>
<td>43,920</td>
</tr>
<tr>
<td>Unfavorable noncontrollable variance</td>
<td>$ 1,632</td>
</tr>
</tbody>
</table>

Alternate Solution

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed manufacturing overhead (as above)</td>
<td>$19,200</td>
</tr>
<tr>
<td>Overhead applied to production</td>
<td>43,920</td>
</tr>
<tr>
<td>Variable manufacturing overhead</td>
<td>26,352</td>
</tr>
<tr>
<td>Unfavorable noncontrollable variance</td>
<td>$ 1,632</td>
</tr>
</tbody>
</table>
VIII. Not-for-Profit and Governmental Accounting

2M85
Answer 5 (10 points)

a. Community Association for Handicapped Children
STATEMENT OF SUPPORT, REVENUE, AND EXPENSES
AND CHANGES IN FUND BALANCES
FOR CURRENT FUNDS
Year Ended June 30, 1984

<table>
<thead>
<tr>
<th>Public support and revenue</th>
<th>Unrestricted</th>
<th>Restricted</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions (net of provision for uncollectible unrestricted pledges of $2,000)</td>
<td>$298,000</td>
<td>$15,000</td>
<td>$313,000</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Membership dues</td>
<td>25,000</td>
<td>—</td>
<td>25,000</td>
</tr>
<tr>
<td>Program service fees</td>
<td>30,000</td>
<td>—</td>
<td>30,000</td>
</tr>
<tr>
<td>Investment income</td>
<td>10,000</td>
<td>—</td>
<td>10,000</td>
</tr>
<tr>
<td>Total revenue</td>
<td>65,000</td>
<td>—</td>
<td>65,000</td>
</tr>
<tr>
<td>Total public support and revenue</td>
<td>363,000</td>
<td>15,000</td>
<td>378,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Unrestricted</th>
<th>Restricted</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Blind children</td>
<td>150,000</td>
<td>—</td>
<td>150,000</td>
</tr>
<tr>
<td>Deaf children</td>
<td>120,000</td>
<td>—</td>
<td>120,000</td>
</tr>
<tr>
<td>Total program services</td>
<td>270,000</td>
<td>—</td>
<td>270,000</td>
</tr>
<tr>
<td>Supporting services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management and general</td>
<td>45,000</td>
<td>4,000</td>
<td>49,000</td>
</tr>
<tr>
<td>Fund-raising</td>
<td>8,000</td>
<td>1,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Total supporting services</td>
<td>53,000</td>
<td>5,000</td>
<td>58,000</td>
</tr>
<tr>
<td>Total expenses</td>
<td>323,000</td>
<td>5,000</td>
<td>328,000</td>
</tr>
</tbody>
</table>

| Excess of public support and revenue over expenses | 40,000 | 10,000 | 50,000 |

| Other changes in fund balances | | | |
| Transfers of endowment fund income | 20,000 | — | 20,000 |
| Fund balances, July 1, 1983 | 38,000 | 3,000 | 41,000 |
| Fund balances, June 30, 1984 | $ 98,000 | $13,000 | $111,000 |
b. Community Association for Handicapped Children

**CURRENT FUNDS BALANCE SHEETS**

*June 30, 1984*

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Fund Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unrestricted</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Investments (at cost, which approximates market)</td>
<td>100,000</td>
</tr>
<tr>
<td>Pledges receivable (less allowances for uncollectibles of $3,000)</td>
<td>9,000</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$150,000</strong></td>
</tr>
</tbody>
</table>

| **Restricted**                              |                                |
| Cash                                        | $ 9,000                        |
| Bequest receivable                          | 5,000                          |
| **Total**                                   | **$14,000**                    |

2N84

**Answer 4 (10 points)**

*City of Solna*

**GENERAL FUND JOURNAL ENTRIES**

*For the Year Ended December 31, 1983*

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated revenues — taxes</td>
<td>$220,000</td>
</tr>
<tr>
<td>Estimated revenues — fines, forfeits, and penalties</td>
<td>80,000</td>
</tr>
<tr>
<td>Estimated revenues — miscellaneous</td>
<td>100,000</td>
</tr>
<tr>
<td>Estimated other financing sources — proceeds of bond issue</td>
<td>200,000</td>
</tr>
<tr>
<td>Appropriations — program operations</td>
<td>$360,000</td>
</tr>
<tr>
<td>Appropriations — general administration</td>
<td>120,000</td>
</tr>
<tr>
<td>Appropriations — capital outlays</td>
<td>80,000</td>
</tr>
<tr>
<td>Appropriations — other financing uses — operating transfers out to special assessment fund</td>
<td>20,000</td>
</tr>
<tr>
<td>Unreserved undesignated fund balance</td>
<td>20,000</td>
</tr>
<tr>
<td>Encumbrances — prior year</td>
<td>12,000</td>
</tr>
<tr>
<td>Appropriations — prior year</td>
<td>12,000</td>
</tr>
</tbody>
</table>
2. Taxes receivable — current  230,000
   Estimated uncollectible taxes — current  9,200
   Revenues — taxes  $220,800

3. Encumbrances — current year  316,000
   Fund balance reserved for encumbrances  316,000

4. Unreserved undesignated fund balance  20,000
   Fund balance designated for capital outlays  20,000

5. Cash  664,000
   Taxes receivable — delinquent  38,000
   Taxes receivable — current  226,000
   Expenditures — capital outlays  4,000
   Revenues — fines, forfeits, and penalties  88,000
   Revenues — miscellaneous  90,000
   Other financing sources — proceeds of bond issue  200,000
   Unreserved undesignated fund balance  18,000

6. Fund balance reserved for encumbrances  302,000
   Encumbrances — prior year  12,000
   Encumbrances — current year  290,000
   Expenditures — program operations  166,000
   Expenditures — general administration  80,000
   Expenditures — capital outlays  62,000
   Vouchers payable  308,000

7. Expenditures — program operations  188,000
   Expenditures — general administration  38,000
   Expenditures — capital outlay  18,000
   Other financing uses — operating transfer out to special assessment fund  20,000
   Vouchers payable  244,000
   Due to special assessment fund  20,000

8. Taxes receivable — current  2,000
   Deferred revenue — taxes  2,000
   Estimated uncollectible taxes — current  3,200
   Revenues — taxes  3,200

9. Vouchers payable  580,000
   Cash  580,000

10. Fund balance reserved for stores inventory  6,000
    Stores inventory — program operations  6,000
a.

Rapapo State University  
SUMMARY JOURNAL ENTRIES  
For the Year Ended July 31, 1983

<table>
<thead>
<tr>
<th>Entry no.</th>
<th>Accounts</th>
<th>Unrestricted</th>
<th></th>
<th></th>
<th>Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>1.</td>
<td>Cash</td>
<td>$3,000,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounts receivable—tuition and fees</td>
<td>362,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenue—tuition and fees</td>
<td>2,500,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deferred revenue—tuition and fees</td>
<td>138,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Deferred revenue—tuition and fees</td>
<td>25,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenue—tuition and fees</td>
<td>25,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Allowance for doubtful accounts</td>
<td>13,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounts receivable—tuition and fees</td>
<td>13,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Provision for uncollectible tuition and fees</td>
<td>8,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Allowance for doubtful accounts</td>
<td>8,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>State appropriation receivable</td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenue—state appropriation</td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Cash</td>
<td>80,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenue—gifts</td>
<td>80,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fund Balance</td>
<td>30,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>30,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Cash</td>
<td>$31,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investments</td>
<td>$25,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fund balance</td>
<td>6,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investments</td>
<td>40,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>40,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>18,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fund balance</td>
<td>18,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Expenditures—general expenses</td>
<td>2,500,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounts payable</td>
<td>2,500,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounts payable</td>
<td>2,525,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>2,525,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>Accounts payable</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9.</td>
<td>Due to other funds</td>
<td>40,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>40,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10.</td>
<td>Expenditures—general expenses</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Prepaid expenses</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

AP-240
Unofficial Answers

2N83
Answer 4 (cont.)

Rapapo State University
STATEMENT OF CHANGES IN FUND BALANCES
For the Year Ended July 31, 1983

<table>
<thead>
<tr>
<th>Current Funds</th>
<th>Unrestricted</th>
<th>Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues and other additions:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tuition and fees</td>
<td>$2,525,000</td>
<td></td>
</tr>
<tr>
<td>State appropriation</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Gifts</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of investments</td>
<td></td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Investment income</td>
<td></td>
<td>18,000</td>
</tr>
<tr>
<td>Total revenues and other additions</td>
<td>2,665,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Expenditures and other deductions:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Educational and general</td>
<td>2,518,000</td>
<td></td>
</tr>
<tr>
<td>Transfer among funds (deduction):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allocation to loan fund</td>
<td>(30,000)</td>
<td></td>
</tr>
<tr>
<td>Net increase for the year</td>
<td>117,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Fund balance at beginning of year</td>
<td>435,000</td>
<td>215,000</td>
</tr>
<tr>
<td>Fund balance at end of year</td>
<td>$552,000</td>
<td>$239,000</td>
</tr>
</tbody>
</table>

2M83
Answer 5 (10 points)

Community Sports Club
TRANSACTIONS
For the Year Ended March 31, 1983

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cash</th>
<th>Revenue — annual dues</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Cr. 20,000</td>
</tr>
<tr>
<td>(1)</td>
<td></td>
<td></td>
<td>$20,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>28,000</td>
</tr>
<tr>
<td>(2)</td>
<td></td>
<td>Revenue — snack bar and soda fountain</td>
<td>28,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>6,000</td>
</tr>
<tr>
<td>(3)</td>
<td></td>
<td>Investment income</td>
<td>6,000</td>
</tr>
<tr>
<td></td>
<td>Expense — house</td>
<td>17,000</td>
<td></td>
</tr>
<tr>
<td>(4)</td>
<td>Expense — snack bar and soda fountain</td>
<td>26,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Expense — general and administrative</td>
<td>11,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounts payable</td>
<td>54,000</td>
<td></td>
</tr>
<tr>
<td>(5)</td>
<td>Accounts payable</td>
<td>55,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>55,000</td>
<td></td>
</tr>
<tr>
<td>(6)</td>
<td>Assessments receivable</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deferred capital support</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>(7)</td>
<td>Cash</td>
<td>Revenue — bequest (unrestricted revenue)</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5,000</td>
<td></td>
</tr>
</tbody>
</table>
Community Sports Club

ADJUSTMENTS
March 31, 1983

(1) Investments $ 7,000
Unrealized gain on investments $ 7,000

(2), (3) Expense — house 9,000
Expense — snack bar and soda fountain 2,000
Expense — general and administrative 1,000
Accumulated depreciation - building 4,000
Accumulated depreciation - furniture and equipment 8,000

(4) Expense — snack bar and soda fountain 4,000
Inventories 4,000

b. Community Sports Club

STATEMENT OF REVENUE, EXPENSES, AND CHANGES IN CUMULATIVE EXCESS OF REVENUE OVER EXPENSES
For the Year Ended March 31, 1983

Revenue

Snack bar and soda fountain sales $28,000
Dues 20,000
Investment income 6,000
Bequest 5,000
Total revenue 59,000

Expenses

Snack bar and soda fountain $32,000
House 26,000
General and Administrative 12,000
Total expenses 70,000

Deficiency of revenue over expenses before unrealized gain on investments (11,000)

Unrealized gain on investments 7,000

Deficiency of revenue over expenses after unrealized gain on investments ( 4,000)

Cumulative excess of revenue over expenses at April 1, 1982 12,000

Cumulative excess of revenue over expenses at March 31, 1983 $ 8,000
Glendora Hospital
STATEMENT OF REVENUES AND EXPENSES
For the Year Ended June 30, 1982

Patient service revenue (Notes A and B) $16,000,000
Alliances and uncollectible accounts (Note A) (3,400,000)
   Net patient service revenue 12,600,000
Other operating revenue (including $160,000 from specific purpose funds) 346,000
   Total operating revenue 12,946,000
Operating expenses (including provision for depreciation of $500,000; Notes A, B, and C) 13,370,000
   Loss from operations (424,000)
Nonoperating revenue:
   Unrestricted gifts and bequests (Note A) 410,000
   Unrestricted income from endowment funds 160,000
   Income from board-designated funds 82,000
   Total nonoperating revenue 652,000
Excess of revenues over expenses $228,000

See accompanying Notes to Financial Statements.

2. Glendora Hospital
NOTES TO FINANCIAL STATEMENTS

Note A—Summary of Significant Accounting Policies

Patient service revenue
Patient service revenue is accounted for at established rates on the accrual basis. Revenue under cost reimbursement agreements is subject to audit and retroactive adjustment by third-party payors. Estimated retroactive adjustments under these agreements are included in allowances.

Gifts and bequests
Gifts and bequests are recorded at fair market values when received.

 Provision for depreciation
Depreciation of property, plant, and equipment is computed on a straight-line basis over the estimated useful lives of the individual assets. However, accelerated depreciation is used to determine reimbursable costs under certain third-party reimbursement agreements. Net cost reimbursement revenue resulting from the difference in depreciation methods is deferred.

Pension costs
Accrued pension costs are funded currently. Prior service cost is amortized over a period of twenty years.

Note B—Cost Reimbursement Agreements
Revenue of $6 million was recognized under cost reimbursement agreements. The net cost reimbursement revenue resulting from the difference in depreciation methods described in Note A amounted to $220,000 and was deferred.

Note C—Pension Costs
Operating expenses include pension costs of $100,000 in connection with a noncontributory pension plan covering substantially all employees. The actuarially computed value of vested and nonvested benefits at year end amounted to $3 million and $350,000, respectively. The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8 percent. The plan's net assets available for benefits at year end was $3,050,000.
### Judbury City
**GENERAL FUND**
**JOURNAL ENTRIES**
*July 1, 1980 to June 30, 1981*  

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>5. Cash</strong></td>
<td></td>
</tr>
<tr>
<td>Revenues—Licenses and permits</td>
<td>485,000</td>
</tr>
<tr>
<td>Revenues—Fines</td>
<td>270,000</td>
</tr>
<tr>
<td>Revenues—Sale of fixed assets</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>6. Encumbrances—General government</strong></td>
<td></td>
</tr>
<tr>
<td>Encumbrances—Police services</td>
<td>1,050,000</td>
</tr>
<tr>
<td>Encumbrances—Fire department services</td>
<td>300,000</td>
</tr>
<tr>
<td>Encumbrances—Public works services</td>
<td>150,000</td>
</tr>
<tr>
<td>Encumbrances—Fire engines</td>
<td>250,000</td>
</tr>
<tr>
<td><strong>7. Expenditures—General government</strong></td>
<td></td>
</tr>
<tr>
<td>Expenditures—Police services</td>
<td>1,440,000</td>
</tr>
<tr>
<td>Expenditures—Fire department services</td>
<td>1,155,000</td>
</tr>
<tr>
<td>Expenditures—Public works services</td>
<td>870,000</td>
</tr>
<tr>
<td>Expenditures—Fire engines</td>
<td>700,000</td>
</tr>
<tr>
<td><strong>8. Vouchers payable</strong></td>
<td></td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>4,565,000</td>
</tr>
<tr>
<td><strong>9. Cash</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>4,600,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Estimated revenues—Property taxes</strong></td>
<td>$4,500,000</td>
</tr>
<tr>
<td><strong>2. Property taxes receivable</strong></td>
<td></td>
</tr>
<tr>
<td>Allowance for uncollectible property taxes</td>
<td>4,650,000</td>
</tr>
<tr>
<td>Revenue—Property taxes</td>
<td>150,000</td>
</tr>
<tr>
<td><strong>3. Cash</strong></td>
<td></td>
</tr>
<tr>
<td>Property taxes receivable</td>
<td>3,900,000</td>
</tr>
<tr>
<td>Delinquent property taxes receivable</td>
<td>3,900,000</td>
</tr>
<tr>
<td>Allowance for uncollectible property taxes</td>
<td>630,000</td>
</tr>
<tr>
<td>Property taxes receivable</td>
<td>150,000</td>
</tr>
<tr>
<td>Allowance for uncollectible delinquent property taxes</td>
<td>630,000</td>
</tr>
<tr>
<td><strong>4. Cash</strong></td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td>300,000</td>
</tr>
<tr>
<td><strong>5. Cash</strong></td>
<td></td>
</tr>
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<td>Revenues—Licenses and permits</td>
<td>485,000</td>
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<td>300,000</td>
</tr>
<tr>
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<tr>
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<tr>
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<tr>
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</tr>
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</tr>
<tr>
<td><strong>9. Cash</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>4,600,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
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<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Estimated revenues—Property taxes</strong></td>
<td>$4,500,000</td>
</tr>
<tr>
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</tr>
<tr>
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<tr>
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<td>150,000</td>
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<tr>
<td><strong>3. Cash</strong></td>
<td></td>
</tr>
<tr>
<td>Property taxes receivable</td>
<td>3,900,000</td>
</tr>
<tr>
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<td>3,900,000</td>
</tr>
<tr>
<td>Allowance for uncollectible property taxes</td>
<td>630,000</td>
</tr>
<tr>
<td>Property taxes receivable</td>
<td>150,000</td>
</tr>
<tr>
<td>Allowance for uncollectible delinquent property taxes</td>
<td>630,000</td>
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<tr>
<td><strong>4. Cash</strong></td>
<td></td>
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<tr>
<td>Notes payable</td>
<td>300,000</td>
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</tbody>
</table>
### Part a.

**City of Merlot**

**CENTRAL GARAGE FUND**

**Journal Entries**

*July 1, 1979 to June 30, 1980*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
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</thead>
<tbody>
<tr>
<td>1. Inventory of materials and supplies</td>
<td>$74,000</td>
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<tr>
<td>Vouchers payable</td>
<td>$74,000</td>
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<tr>
<td>To record purchases on account</td>
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<tr>
<td>2. Materials and supplies expense</td>
<td>96,000</td>
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<tr>
<td>Inventory of materials and supplies</td>
<td>96,000</td>
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<tr>
<td>To record ending inventory and materials and supplies used</td>
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<tr>
<td>3. Personal service expense</td>
<td>230,000</td>
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<tr>
<td>Cash</td>
<td>230,000</td>
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<tr>
<td>To record personal service expense paid</td>
<td></td>
</tr>
<tr>
<td>4. Utility expense</td>
<td>30,000</td>
</tr>
<tr>
<td>Cash</td>
<td>30,000</td>
</tr>
<tr>
<td>To record payment of utility charges</td>
<td></td>
</tr>
<tr>
<td>5. Depreciation expense—building</td>
<td>5,000</td>
</tr>
<tr>
<td>Depreciation expense—machinery and equipment</td>
<td>8,000</td>
</tr>
<tr>
<td>Allowance for depreciation—building</td>
<td>5,000</td>
</tr>
<tr>
<td>Allowance for depreciation—machinery and equipment</td>
<td>8,000</td>
</tr>
<tr>
<td>To record depreciation</td>
<td></td>
</tr>
<tr>
<td>6. Due from General Fund</td>
<td>262,000</td>
</tr>
<tr>
<td>Due from Water and Sewer Fund</td>
<td>84,000</td>
</tr>
<tr>
<td>Due from Special Revenue Fund</td>
<td>32,000</td>
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<tr>
<td>Service Revenue</td>
<td>378,000</td>
</tr>
<tr>
<td>To record billings to departments for services rendered</td>
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</tr>
<tr>
<td>7. Cash</td>
<td>376,000</td>
</tr>
<tr>
<td>Due from General Fund</td>
<td>276,000</td>
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<tr>
<td>Due from Water and Sewer Fund</td>
<td>84,000</td>
</tr>
<tr>
<td>Due from Special Revenue Fund</td>
<td>16,000</td>
</tr>
<tr>
<td>To record collection of receivables</td>
<td></td>
</tr>
</tbody>
</table>

**City of Merlot**

**CENTRAL GARAGE FUND**

**Closing Entries**

*June 30, 1980*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vouchers payable</td>
<td>98,000</td>
</tr>
<tr>
<td>Cash</td>
<td>98,000</td>
</tr>
<tr>
<td>To record payment of vouchers</td>
<td></td>
</tr>
</tbody>
</table>

### Part b.

**City of Rom**

**Journal Entries to Record Budgeted and Actual Transactions**

*For the Year Ended June 30, 1980*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Estimated revenues</td>
<td></td>
</tr>
<tr>
<td>(various subaccounts)</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Appropriations (various subaccounts)</td>
<td>$1,940,000</td>
</tr>
<tr>
<td>Fund balance—unreserved</td>
<td>60,000</td>
</tr>
<tr>
<td>To record budget</td>
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</tr>
<tr>
<td>2. Taxes receivable</td>
<td>1,870,000</td>
</tr>
<tr>
<td>Allowance for uncollectible taxes</td>
<td></td>
</tr>
<tr>
<td>Revenues—taxes</td>
<td>10,000</td>
</tr>
<tr>
<td>To record tax levy</td>
<td></td>
</tr>
<tr>
<td>3. Cash</td>
<td>1,820,000</td>
</tr>
<tr>
<td>Allowance for uncollectible taxes</td>
<td></td>
</tr>
<tr>
<td>Taxes receivable</td>
<td>8,000</td>
</tr>
<tr>
<td>To record tax collections</td>
<td></td>
</tr>
<tr>
<td>4. Encumbrances (various subaccounts)</td>
<td>1,070,000</td>
</tr>
<tr>
<td>Fund balance—reserved for encumbrances</td>
<td></td>
</tr>
<tr>
<td>To record encumbrances</td>
<td>1,070,000</td>
</tr>
</tbody>
</table>
2M81
Answer 4 (10 points)

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.</td>
<td>Fund balance—reserved for encumbrances</td>
<td>1,000,000</td>
</tr>
<tr>
<td></td>
<td>Encumbrances (various subaccounts)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>To reverse encumbrances</td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Expenditures (various subaccounts)</td>
<td>1,840,000</td>
</tr>
<tr>
<td></td>
<td>Vouchers payable</td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record expenditures</td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Vouchers payable</td>
<td>1,852,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record payment of vouchers</td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>Fund balance—unreserved</td>
<td>140,000</td>
</tr>
<tr>
<td></td>
<td>Revenues—taxes</td>
<td>1,860,000</td>
</tr>
<tr>
<td></td>
<td>Estimated revenues (various subaccounts)</td>
<td>2,000,000</td>
</tr>
<tr>
<td></td>
<td>To close actual and estimated revenues to fund balance</td>
<td></td>
</tr>
<tr>
<td>9.</td>
<td>Appropriations (various subaccounts)</td>
<td>1,940,000</td>
</tr>
<tr>
<td></td>
<td>Expenditures (various subaccounts)</td>
<td>1,840,000</td>
</tr>
<tr>
<td></td>
<td>Encumbrances (various subaccounts)</td>
<td>70,000</td>
</tr>
<tr>
<td></td>
<td>Fund balance—unreserved</td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>To close expenditures, encumbrances, and appropriations to fund balance</td>
<td></td>
</tr>
</tbody>
</table>
EXAMINATION IN ACCOUNTING PRACTICE — PART I

November 6, 1985; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>No.</th>
<th>Estimated Minutes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Minimum</td>
</tr>
<tr>
<td>1</td>
<td>45</td>
</tr>
<tr>
<td>2</td>
<td>45</td>
</tr>
<tr>
<td>3</td>
<td>45</td>
</tr>
<tr>
<td>4</td>
<td>45</td>
</tr>
<tr>
<td>5</td>
<td>40</td>
</tr>
<tr>
<td>Total</td>
<td>220</td>
</tr>
</tbody>
</table>

INSTRUCTIONS TO CANDIDATES

(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since 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.

3. Support all problem-type answers with properly labeled and legible calculations that can be identified as sources of amounts in formal schedules, entries, worksheets, or other answers, to show how your final answer was derived. Computation sheets should identify the question to which they relate, be placed immediately following the answer to that question, and be numbered in sequence with the other pages. Failure to enclose supporting calculations may result in loss of grading points because it may be impossible to determine how your amounts were computed.

4. For Question Number 5 be sure to include the completed tear-out worksheet in the proper sequence with other answer sheets.

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

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 —— 45 to 55 minutes)

Instructions

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

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

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to $5,260,000; sales returns and allowances reduced the amounts owed by $160,000. How much were net sales last year for Baker Company?

a. $4,800,000
b. $5,100,000
c. $5,200,000
d. $5,260,000

Answer Sheet

97. [ ] a [ ] b [ ] c [ ] d

Items to be Answered

1. Day, Inc., began business on January 1, 1984, and at December 31, 1984, Day had the following investment portfolios of marketable equity securities:

<table>
<thead>
<tr>
<th>In current assets</th>
<th>In noncurrent assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate cost</td>
<td>$150,000</td>
</tr>
<tr>
<td>Aggregate market value</td>
<td>120,000</td>
</tr>
<tr>
<td>Net unrealized loss</td>
<td>$30,000</td>
</tr>
<tr>
<td></td>
<td>$225,000</td>
</tr>
<tr>
<td></td>
<td>185,000</td>
</tr>
<tr>
<td></td>
<td>$40,000</td>
</tr>
</tbody>
</table>

None of the declines is judged to be other than temporary. Valuation allowances at December 31, 1984, should be established with corresponding charges against:

<table>
<thead>
<tr>
<th>Income</th>
<th>Stockholders' equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $70,000</td>
<td>$0</td>
</tr>
<tr>
<td>b. $40,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>c. $30,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>d. $0</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

2. On December 31, 1984, West Company had the following cash balances:

Cash in banks $1,800,000
Petty cash funds (all funds were reimbursed on 12/31/84) 50,000

Cash in banks includes $600,000 of compensating balances against short-term borrowing arrangements at December 31, 1984. The compensating balances are not legally restricted as to withdrawal by West. In the current assets section of West's December 31, 1984, balance sheet, what total amount should be reported as cash?

a. $1,200,000
b. $1,250,000
c. $1,800,000
d. $1,850,000

3. At the end of its first year of operations, December 31, 1984, Mill Company had accounts receivable of $600,000, net of the related allowance for doubtful accounts. During 1984 Mill recorded charges to bad debt expense of $90,000 and wrote off $20,000 of uncollectible accounts receivable. In its December 31, 1984, balance sheet, how much should Mill report as accounts receivable before the allowance for doubtful accounts?

a. $600,000
b. $620,000
c. $670,000
d. $710,000

4. Farr Company accepted a $50,000 face value, 6-month, 10% note dated April 15, 1985, from a customer. The same date Farr discounted the note at Eagle National Bank at a 12% discount rate. How much cash should Farr receive from the bank on April 15, 1985?

a. $48,400
b. $49,350
c. $49,500
d. $52,500

5. The following information appears in Dix Company records for the year ended December 31, 1984:

| Merchandise inventory, 1/1/84 | $275,000 |
| Purchases                     | 1,125,000 |
| Sales                        | 1,500,000 |

On December 31, 1984, a physical inventory revealed that the ending inventory was only $300,000. Dix's gross profit on sales has remained constant at 30% in recent years. Dix suspects that some inventory may have been pilfered by one of the new employees. At December 31, 1984, what is the estimated cost of missing inventory?

a. $25,000
b. $50,000
c. $75,000
d. $100,000
6. On October 1, 1984, Yost Company purchased 400 of the $1,000 face value, 10% bonds of Pell, Inc., for $440,000, which includes accrued interest of $10,000. The bonds, which mature on January 1, 1991, pay interest semiannually on January 1 and July 1. Yost uses the straight-line method of amortization and appropriately recorded the bonds as a long-term investment. The bonds should be shown on Yost’s December 31, 1984, balance sheet at
   a. $428,400
   b. $428,800
   c. $430,000
   d. $440,000

7. The following accounts were abstracted from Cox Company’s unadjusted trial balance at December 31, 1984:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$500,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>4,000</td>
</tr>
<tr>
<td>Net credit sales</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

Cox estimates that 3% of the gross accounts receivable will become uncollectible. After adjustment at December 31, 1984, the allowance for doubtful accounts should have a credit balance of
   a. $11,000
   b. $15,000
   c. $19,000
   d. $60,000

8. On January 1, 1984, King Company’s allowance for doubtful accounts had a credit balance of $15,000. During 1984 King: (1) charged $32,000 to bad debt expense, (2) wrote off $23,000 of uncollectible accounts receivable, and (3) unexpectedly recovered $6,000 of bad debts written off in the prior year. The allowance for doubtful accounts balance at December 31, 1984, should be
   a. $47,000
   b. $32,000
   c. $30,000
   d. $24,000

9. The following information applied to Ott Company for 1984:
   Merchandise purchased for resale $600,000
   Freight-in 15,000
   Interest on notes payable to vendors 6,000
   Purchase returns 3,000

Ott’s inventorable cost for 1984 was
   a. $600,000
   b. $603,000
   c. $612,000
   d. $618,000

10. The following information is available from the records of Bell Company for the year ended December 31, 1984:

<table>
<thead>
<tr>
<th>At cost</th>
<th>At retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/84</td>
<td>$360,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>1,320,000</td>
</tr>
<tr>
<td>Additional markups</td>
<td>3,000</td>
</tr>
<tr>
<td>Markdowns</td>
<td>40,000</td>
</tr>
<tr>
<td>Sales</td>
<td>1,920,000</td>
</tr>
</tbody>
</table>

Under the approximate lower of average cost or market retail method, Bell’s inventory at December 31, 1984, is
   a. $224,000
   b. $240,000
   c. $320,000
   d. $480,000

11. Clay Company started construction of a new office building on January 1, 1984, and moved into the finished building on July 1, 1985. Of the building’s $2,500,000 total cost, $2,000,000 was incurred in 1984 evenly throughout the year. Clay’s incremental borrowing rate was 12% throughout 1984, and the total amount of interest incurred by Clay during 1984 was $102,000. What amount should Clay report as capitalized interest at December 31, 1984?
   a. $102,000
   b. $120,000
   c. $150,000
   d. $240,000

12. On July 1, 1985, Town Company purchased for $540,000 a warehouse building and the land on which it is located. The following data were available concerning the property:

<table>
<thead>
<tr>
<th>Current appraised value</th>
<th>Seller’s original cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$200,000</td>
</tr>
<tr>
<td>Warehouse building</td>
<td>300,000</td>
</tr>
<tr>
<td></td>
<td>$500,000</td>
</tr>
</tbody>
</table>

Town should record the land at
   a. $140,000
   b. $180,000
   c. $200,000
   d. $216,000

13. On July 1, 1985, a fire destroyed $200,000 of Lane Company’s $600,000 inventory (fair market values). Lane carried a $240,000 fire insurance policy with an 80% co-insurance clause. What is the maximum amount of insurance that Lane can collect as a result of this loss?
   a. $200,000
   b. $192,000
   c. $160,000
   d. $100,000
14. Lock Company sells, for cash, appliance service contracts agreeing to service appliances for a one-year, two-year, or three-year period. Cash receipts from contracts are credited to the unearned service contract revenues account which had an unadjusted balance of $1,580,000 at December 31, 1984. Service contract costs are charged, as incurred, to the service contract expense account which had a balance of $370,000 at December 31, 1984. Outstanding service contracts at December 31, 1984, expire as follows:

During 1985 — $450,000
During 1986 — 350,000
During 1987 — 275,000

At December 31, 1984, how much should Lock report as unearned service contract revenues?

a. $ 505,000
b. $ 705,000
c. $1,075,000
d. $1,210,000

15. On January 2, 1984, Terry Company signed a ten-year noncancelable lease for a machine, stipulating annual payments of $20,000 starting at the end of the first year, with title passing to Terry at the expiration of the lease. The machine has an estimated useful life of 12 years, with no salvage value. Terry uses straight-line depreciation for all of its fixed assets. Aggregate lease payments were determined to have a present value of $123,000, based on implicit interest of 10%. For 1984, Terry should record depreciation (amortization) of

a. $0
b. $10,250
c. $12,300
d. $20,000

16. Ames Company adopted a pension plan on January 1, 1983, on a funded, noncontributory basis. Ames elected to amortize past service cost over twelve years and to fund past service cost over ten years. Normal cost is to be funded as incurred each year. The following schedule reflects normal cost, amortization of past service cost and funding for 1983 and 1984:

<table>
<thead>
<tr>
<th>Year</th>
<th>Normal Cost</th>
<th>12-Year Amortization</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>$ 90,000</td>
<td>100,000</td>
</tr>
<tr>
<td>1984</td>
<td>$ 95,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Reduction for interest — 1,155
Past service cost — 100,000
10-year funding — 109,628

In its December 31, 1984, balance sheet, Ames should report a deferred charge for pension cost at

a. $10,783
b. $13,845
c. $14,628
d. $20,411

17. Eliot Corporation's liabilities at December 31, 1984, were as follows:

Accounts payable & accrued interest $200,000
12% note payable issued November 1, 1984, maturing July 1, 1985 60,000
10% debentures payable, next annual principal installment of $100,000 due February 1, 1985 700,000

On March 1, 1985, Eliot consummated a noncancelable agreement with the lender to refinance the 12% note payable 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 any of the agreement’s provisions. Eliot's December 31, 1984, financial statements were issued on March 31, 1985.

In its December 31, 1984, balance sheet, Eliot should report current liabilities at

a. $200,000
b. $260,000
c. $300,000
d. $360,000

18. Apex Company employees earn two weeks of paid vacation for each year of employment. Unused vacation time can be accumulated and carried forward to succeeding years, and will be paid at the salary in effect when the vacation is taken. As of December 31, 1984, when Paul's salary was $600 per week, Paul had earned 18 weeks vacation time and had used 12 weeks of accumulated vacation time. At December 31, 1984, how much should Apex carry as a liability for Paul's accumulated vacation time?

a. $0
b. $1,200
c. $3,600
d. $7,200

19. On December 31, 1984, a building owned by Glen Company was totally destroyed by fire. The building was covered by a fire insurance policy with a face value of $250,000. Other pertinent information as of December 31, 1984, is as follows:

- Building — at book value $260,000
- Building — at fair value 275,000
- Removal and clean-up cost 3,000

During January 1985, before the 1984 financial statements were issued, Glen received insurance proceeds of $250,000. What amount should Glen report on its 1984 income statement as involuntary conversion loss?

a. $10,000
b. $13,000
c. $25,000
d. $28,000
20. During 1983 Dall Company 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 sale and 4% in the second 12 months following sale. Sales and actual warranty expenditures for the years ended December 31, 1983 and 1984, are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Sales</th>
<th>Warranty Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>$300,000</td>
<td>$4,500</td>
</tr>
<tr>
<td>1984</td>
<td>$500,000</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>$800,000</td>
<td>$19,500</td>
</tr>
</tbody>
</table>

At December 31, 1984, Dall should report an estimated warranty liability of

a. $28,500
b. $22,500
c. $5,000
d. $0

Number 2 (Estimated time —— 45 to 55 minutes)

Instructions

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

Items to be Answered

21. On January 1, 1985, Dean Company issued ten-year bonds with a face value of $1,000,000 and a stated interest rate of 8% per year payable semiannually July 1 and January 1. The bonds were sold to yield 10%. Present value factors are as follows:

<table>
<thead>
<tr>
<th>Periods at 10%</th>
<th>Present Value of 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>.386</td>
</tr>
<tr>
<td>20</td>
<td>.223</td>
</tr>
<tr>
<td>5</td>
<td>.377</td>
</tr>
</tbody>
</table>

Present value of an annuity of 1 for 10 periods at 10%: 6.145
Present value of an annuity of 1 for 20 periods at 5%: 12.462

The total issue price of the bonds is

a. $875,480
b. $877,600
c. $980,000
d. $1,000,000

22. Moore Company sells magazine subscriptions for one to three-year periods. The magazine subscriptions collected in advance account had a balance of $1,800,000 at December 31, 1983. Information for the year 1984 is as follows:

<table>
<thead>
<tr>
<th>Cash receipts from subscribers</th>
<th>$2,300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Magazine subscriptions revenue</td>
<td>1,600,000</td>
</tr>
</tbody>
</table>

In its December 31, 1984, balance sheet, how much should Moore report as the balance for magazine subscriptions collected in advance?

a. $1,100,000
b. $2,100,000
c. $2,300,000
d. $2,500,000

23. On December 31, 1984, Cobb Company leased a new machine from Gill Company. The following data relate to the lease transaction:

- The machine has an estimated useful life of eight years which coincides with the lease term.
- Lease rentals consist of eight equal annual payments of $100,000, the first of which was paid December 31, 1984.
- Gill's implicit interest rate is 12%, which is known by Cobb.
- Cobb's incremental borrowing rate is 14% at December 31, 1984.
- Present value of an annuity of 1 in advance for eight periods at 12% is 5.56.
- Present value of an annuity of 1 in advance for eight periods at 14% is 5.29.

In its December 31, 1984, balance sheet, Cobb should report a capitalized lease liability of

a. $429,000
b. $456,000
c. $529,000
d. $556,000

24. On January 1, 1985, Carr, Inc., issued its 10% bonds in the face amount of $400,000, which mature on January 1, 1995. The bonds were issued for $354,000 to yield 12%, resulting in a bond discount of $46,000. Carr uses the interest method of amortizing bond discount. Interest is payable semiannually on July 1 and January 1. For the six months ended June 30, 1985, Carr should report bond interest expense at

a. $24,000
b. $22,300
c. $21,240
d. $20,000
25. Eller Company has outstanding at December 31, 1984, several long-term borrowings with annual sinking fund payments and maturities as follows:

<table>
<thead>
<tr>
<th>Sinking fund payments</th>
<th>Maturities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>1986</td>
<td>1,000,000</td>
</tr>
<tr>
<td>1987</td>
<td>1,000,000</td>
</tr>
<tr>
<td>1988</td>
<td>1,500,000</td>
</tr>
<tr>
<td>1989</td>
<td>1,500,000</td>
</tr>
<tr>
<td>1990</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>

Eller appropriately provides footnote disclosures in its 1984 annual report for long-term borrowings which include sinking fund payments and maturities for each of the next five years. The combined aggregate amount for 1989, the fifth year, should be stated as

a. $4,500,000
b. $5,000,000
c. $7,500,000
d. $9,500,000

26. On January 1, 1981, Bart Company purchased equipment at a cost of $105,000. The equipment was estimated to have a useful life of five years and a salvage value of $15,000. Bart uses the sum-of-the-years' digits method of depreciation. What should the accumulated depreciation be at December 31, 1984?

a. $98,000
b. $84,000
c. $70,000
d. $60,000

27. Ward 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, 1984, before year-end adjustment. Additional data are as follows:

- On December 27, 1984, Ward authorized a customer to return, for full credit, goods shipped and billed at $50,000 on December 15, 1984. The returned goods were received by Ward on January 4, 1985, and a $50,000 credit memo was issued on the same date.
- Goods with an invoice amount of $80,000 were billed to a customer on January 3, 1985. The goods were shipped on December 31, 1984.
- On January 5, 1985, a customer notified Ward that goods billed and shipped on December 23, 1984, were lost in transit. The invoice amount was $100,000.

Ward's adjusted net sales for 1984 should be

a. $2,330,000
b. $2,280,000
c. $2,250,000
d. $2,230,000

28. Green Company, which began operations on January 1, 1984, appropriately uses the installment method of accounting. The following information is available for 1984:

<table>
<thead>
<tr>
<th>Gross profit on sales</th>
<th>40%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred gross profit at 12/31/84</td>
<td>$240,000</td>
</tr>
<tr>
<td>Cash collected, including down payments</td>
<td>450,000</td>
</tr>
</tbody>
</table>

What is the total amount of Green's installment sales for 1984?

a. $600,000
b. $690,000
c. $850,000
d. $1,050,000

29. On January 1, 1984, Rex Company leased a machine to Lee Company for eight years, with $10,000 payments due at the beginning of each year. The machine cost Rex $47,900. The lease is appropriately accounted for as a sales-type lease by Rex. The present value of all rent payments over the lease term discounted appropriately at 10% was $58,700. The estimated salvage value of the machine at the end of eight years is equal to the disposal costs. How much interest income should Rex record from the lease for the year ended December 31, 1984?

a. $4,790
b. $4,870
c. $5,870
d. $7,000

30. Pine Construction, Inc., has consistently used the percentage of completion method of recognizing income. In 1984 Pine started work on a $9,000,000 construction contract, which was completed in 1985. The accounting records disclosed the following data for 1984:

<table>
<thead>
<tr>
<th>Progress billings</th>
<th>$3,300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs incurred</td>
<td>2,700,000</td>
</tr>
<tr>
<td>Collections</td>
<td>2,100,000</td>
</tr>
<tr>
<td>Estimated cost to complete</td>
<td>5,400,000</td>
</tr>
</tbody>
</table>

How much income should Pine have recognized in 1984?

a. $300,000
b. $450,000
c. $600,000
d. $700,000

31. Burg, Inc., issued $500,000 face amount of 10% bonds with interest payable on January 1 and July 1. The bonds were called in at 103 on July 1, 1985, and retired. Unamortized bond discount amounted to $40,000 at July 1, 1985. Burg's income tax rate is 40% for 1985. How much loss should Burg report on this early extinguishment of debt?

a. $15,000
b. $22,000
c. $33,000
d. $55,000
32. Information pertaining to dividends from Fay Company’s common stock investments during the year ended December 31, 1984, is as follows:

- Fay owns a 2% interest in Beal Corporation, which declared a cash dividend of $300,000 on November 26, 1984, to shareholders of record on December 21, 1984, and payable on January 10, 1985.
- On October 15, 1984, Fay received a liquidating dividend of $10,000 from Clay Mining Corporation. Fay owns a 5% interest in Clay.

How much dividend income should Fay report in its 1984 income statement?

a. $0
b. $6,000
c. $10,000
d. $16,000

33. During 1983 a textbook written by Burr Company personnel was sold to Fox Publishing, Inc., for royalties of 10% on sales. Royalties are receivable semiannually on March 31, for sales in July through December of the prior year, and on September 30, for sales in January through June of the same year.

- Royalty income of $18,000 was accrued at 12/31/83 for the period July — December 1983.
- Royalty income of $20,000 was received on 3/31/84, and $26,000 on 9/30/84.
- Burr learned from Fox that sales subject to royalty were estimated at $270,000 for the last half of 1984.

In its income statement for 1984, Burr should report royalty income at

a. $46,000
b. $48,000
c. $53,000
d. $55,000

34. On January 1, 1985, Kern Company sold a machine to Burns Company. Burns signed a noninterest-bearing note requiring payment of $30,000 annually for seven years. The first payment was made on January 1, 1985. The prevailing rate of interest for this type of note at date of issuance was 10%. Information on present value factors is as follows:

<table>
<thead>
<tr>
<th>Periods</th>
<th>Present value of 1 at 10%</th>
<th>Present value of ordinary annuity of 1 at 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>.56</td>
<td>4.36</td>
</tr>
<tr>
<td>7</td>
<td>.51</td>
<td>4.87</td>
</tr>
</tbody>
</table>

Kern should record the sale in January 1985 at

a. $107,100
b. $130,800
c. $146,100
d. $160,800

35. Lundy, a U.S. corporation, bought inventory items from a supplier in West Germany on November 5, 1984, for 50,000 marks, when the spot rate was $.4295. At Lundy’s December 31, 1984, year end the spot rate was $.4245. On January 15, 1985, Lundy bought 50,000 marks at the spot rate of $.4345 and paid the invoice. How much should Lundy report in its income statements for 1984 and 1985 as foreign exchange gain or (loss)?

<table>
<thead>
<tr>
<th></th>
<th>1984</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$250</td>
<td>($500)</td>
</tr>
<tr>
<td>b.</td>
<td>($250)</td>
<td>$0</td>
</tr>
<tr>
<td>c.</td>
<td>$0</td>
<td>($250)</td>
</tr>
<tr>
<td>d.</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

36. Hall Company owns an office building and leases the offices under a variety of rental agreements involving rent paid monthly in advance and rent paid annually in advance. Not all tenants make timely payments of their rent. Hall’s balance sheets contained the following data:

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rentals receivable</td>
<td>$4,800</td>
<td>$6,200</td>
</tr>
<tr>
<td>Unearned rentals</td>
<td>16,000</td>
<td>12,000</td>
</tr>
</tbody>
</table>

During 1984 Hall received $40,000 cash from tenants. How much rental revenue should Hall record for 1984?

a. $34,600
b. $37,400
c. $42,600
d. $45,400

37. Zeno Menswear, Inc., maintains a markup of 60% based on cost. The company’s selling and administrative expenses average 30% of sales. For 1984 sales amounted to $960,000. Zeno’s cost of goods sold and operating profit for 1984 are

<table>
<thead>
<tr>
<th>Cost of goods sold</th>
<th>Operating profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $576,000</td>
<td>$96,000</td>
</tr>
<tr>
<td>b. $576,000</td>
<td>$288,000</td>
</tr>
<tr>
<td>c. $600,000</td>
<td>$72,000</td>
</tr>
<tr>
<td>d. $600,000</td>
<td>$288,000</td>
</tr>
</tbody>
</table>

38. On January 1, 1984, Orr Company bought a building which had an assessed value of $220,000 on the date of purchase. Orr gave as consideration a $400,000 noninterest bearing note due on January 1, 1987. 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, 1984, was 10%. The present value of 1 at 10% for three periods is 0.75. What amount of interest expense should be included in Orr’s 1984 income statement?

a. $22,000
b. $30,000
c. $33,333
d. $40,000
39. Poe Company's depreciation policy on machinery and equipment is as follows:

- A full year's depreciation is taken in the year of an asset's acquisition.
- No depreciation is taken in the year of an asset's disposition.
- The estimated useful life is five years.
- The straight-line method is used.

On June 30, 1985, Poe sold for $57,500 a machine acquired in 1982 for $105,000. The accumulated depreciation for this machine was $54,000 at December 31, 1984, and the original estimated salvage value was $15,000. How much gain or (loss) on the disposal should Poe record in 1985?

a. $ 3,500  
   b. $ 6,500  
   c. ($ 8,500)  
   d. $15,500

40. In January 1984 Huff Mining Corporation purchased a mineral mine for $3,600,000 with removable ore estimated by geological surveys at 2,160,000 tons. The property has an estimated value of $360,000 after the ore has been extracted. Huff incurred $1,080,000 of development costs preparing the property for the extraction of ore. During 1984, 270,000 tons were removed and 240,000 tons were sold. For the year ended December 31, 1984, Huff should include what amount of depletion in its cost of goods sold?

a. $360,000  
   b. $405,000  
   c. $480,000  
   d. $540,000

Number 3 (Estimated time —— 45 to 55 minutes)

Instructions

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

Items to be Answered

41. In October 1984 Allen Company exchanged a used packaging machine, having a book value of $120,000, for a dissimilar new machine and paid a cash difference of $15,000. The market value of the used packaging machine was determined to be $140,000. In its income statement for the year ended December 31, 1984, how much gain should Allen recognize on this exchange?

a. $0  
   b. $ 5,000  
   c. $15,000  
   d. $20,000

42. Colt Company prepared an aging of its accounts receivable at December 31, 1984, and determined that the net realizable value of the receivables is $125,000. Additional information is available as follows:

<table>
<thead>
<tr>
<th>Allowance for doubtful accounts</th>
<th>at 1/1/84 — credit balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts written off as uncollectible during 1984</td>
<td>11,500</td>
</tr>
<tr>
<td>Accounts receivable at 12/31/84</td>
<td>135,000</td>
</tr>
</tbody>
</table>

For the year ended December 31, 1984, Colt's bad debt expense would be

a. $ 7,500  
   b. $10,000  
   c. $11,500  
   d. $12,500

43. On January 1, 1984, Marsh Company sold an airplane with an estimated useful life of ten years. At the same time, Marsh leased back the airplane for three years under a lease classified as an operating lease. Pertinent data are:

|                         |                         
|-------------------------|-------------------------|
| Sales price             | $500,000                |
| Book value of airplane  | 100,000                 |
| Monthly rental under leaseback | 5,100              |
| Present value of lease rentals | 153,000            |

For the year ended December 31, 1984, Marsh's rent expense for the airplane should be

a. $0  
   b. $10,200  
   c. $51,000  
   d. $61,200

44. On January 3, 1983, Trapp Company purchased as a long-term investment 10,000 shares of Lee Corporation common stock for $30 per share. On December 31, 1983, the market price of the stock was $25 per share, reflecting a temporary decline in market value. On December 10, 1984, Trapp sold all 10,000 shares of Lee stock for $10 per share. For the year ended December 31, 1984, Trapp should include in its income from continuing operations a loss on disposal of long-term investment of

a. $0  
   b. $ 50,000  
   c. $150,000  
   d. $200,000

45. An inventory loss from market decline of $900,000 occurred in May 1984. Kerr Company recorded this loss in May 1984 after its March 31, 1984, quarterly income statement was issued. None of this loss was recovered by the end of 1984. How much of the inventory loss should be recognized in Kerr's quarterly income statement for the three months ended December 31, 1984?

a. $0  
   b. $225,000  
   c. $300,000  
   d. $900,000
46. On January 1, 1984, Beal Corporation granted stock options to key employees for the purchase of 20,000 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, 1986, by grantees still in the employ of the company. The market price of Beal's common stock was $33 per share at the date of grant. No stock options were terminated during the year. How much should Beal charge to compensation expense for the year ended December 31, 1984?  
   a. $0  
   b. $40,000  
   c. $80,000  
   d. $160,000  

47. Mall Corporation's pretax book income was $1,400,000 for the year ended December 31, 1984. Mall's taxable income for 1984 was $1,200,000, and the difference is due to the following:  

| Description                             | Amount  
|-----------------------------------------|---------  
| Interest on municipal bonds             | $60,000  
| Lower depreciation per books            | $140,000  
| **Total**                               | **$200,000**  

Assuming an income tax rate of 40%, what is the current portion of Mall's total income tax expense for 1984?  
   a. $456,000  
   b. $480,000  
   c. $536,000  
   d. $560,000  

48. Rice, Inc., incurred the following losses, net of applicable taxes, for the year ended December 31, 1984:  

| Description                                      | Amount  
|-------------------------------------------------|---------  
| Loss on disposal of a segment of Rice's business | $350,000  
| Foreign currency transaction loss due to major devaluation | $450,000  

How much should Rice report as extraordinary losses in its 1984 income statement?  
   a. $0  
   b. $350,000  
   c. $450,000  
   d. $800,000  

49. On January 2, 1982, Garr Company acquired machinery at a cost of $320,000. This machinery was being depreciated by the double declining balance method over an estimated useful life of eight years, with no residual value. At the beginning of 1984, it was decided to change to the straight-line method of depreciation. Ignoring income tax considerations, the cumulative effect of this accounting change is  
   a. $0  
   b. $60,000  
   c. $65,000  
   d. $140,000  

50. On January 1, 1984, Black Company changed its inventory cost flow method to FIFO from LIFO for both financial statement and income tax reporting purposes. The change resulted in a $600,000 increase in the beginning inventory at January 1, 1984. Ignoring income taxes, the accounting change should be reported by Black in its 1984  
   a. Income statement as a $600,000 debit.  
   b. Retained earnings statement as a $600,000 debit adjustment to the beginning balance.  
   c. Income statement as a $600,000 credit.  
   d. Retained earnings statement as a $600,000 credit adjustment to the beginning balance.  

51. Lewis Company was formed on January 1, 1983. Selected balances from the historical cost balance sheet at December 31, 1984, were as follows:  

| Description                                      | Amount  
|-------------------------------------------------|---------  
| Land purchased in 1983                         | $120,000  
| Investment in nonconvertible bonds purchased in 1983, and expected to be held to maturity | $60,000  
| Long-term debt                                  | $80,000  

The average Consumer Price Index was 100 for 1983, and 110 for 1984. In a supplementary constant dollar balance sheet (adjusted for changing prices) at December 31, 1984, these selected account balances should be shown as  

| Description | Land | Investment | Long-term debt  
|-------------|------|------------|-----------------  
| a.          | $120,000 | $60,000 | $88,000  
| b.          | $120,000 | $66,000 | $88,000  
| c.          | $132,000 | $60,000 | $80,000  
| d.          | $132,000 | $66,000 | $80,000  

52. At December 31, 1984, Dorr, Inc., has a net operating loss carryforward of $90,000 available to offset future taxable income. At this date, the realization of the tax benefit of the carryforward is probable, but not assured beyond any reasonable doubt. Assuming an income tax rate of 40%, what amount of the potential carryforward tax benefit should be reported in the income statement for the year ended December 31, 1984?  
   a. $0  
   b. $36,000  
   c. $54,000  
   d. $90,000  

53. Mann, Inc., has a bonus plan covering all employees. The total bonus is equal to 10% of Mann's preliminary (prebonus, pretax) income reduced by the income tax (computed on the preliminary income less the bonus itself). Mann's preliminary income for 1984 is $200,000 and the income tax rate is 40%. How much is the bonus for 1984?  
   a. $10,800  
   b. $12,000  
   c. $12,500  
   d. $20,000  

AP-255
Items 54 and 55 are based on the following data:

Information relating to the capital structure of Parke Corporation is as follows:

<table>
<thead>
<tr>
<th>December 31</th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>90,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Preferred stock, convertible into 30,000 shares of common</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>10% convertible bonds, convertible into 20,000 shares of common</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

During 1984 Parke paid $45,000 dividends on the preferred stock, which is considered a common stock equivalent. The convertible bonds are not considered common stock equivalents. Parke’s net income for 1984 was $980,000 and the income tax rate was 40%.

54. For the year ended December 31, 1984, the primary earnings per share is
   a. $10.89
   b. $10.39
   c. $8.17
   d. $7.79

55. For the year ended December 31, 1984, the fully diluted earnings per share is
   a. $9.82
   b. $8.29
   c. $7.71
   d. $7.43

56. Wall Corporation’s books disclosed the following information as of and for the year ended December 31, 1984:

Net credit sales $3,000,000
Net cash sales 480,000
Accounts receivable at beginning 400,000
Accounts receivable at end 800,000

Wall’s accounts receivable turnover is
   a. 3.75 times.
   b. 4.35 times.
   c. 5.00 times.
   d. 5.80 times.

Items 57 and 58 are based on the following data:

Mr. & Mrs. Taft are applying for a bank loan and the bank has requested a personal statement of financial condition as of December 31, 1984. Included in their assets and liabilities at this date are the following:

Assets

Mr. Taft owns 50% of the common stock of Dee Corporation. A shareholders’ agreement restricts the sale of the stock and, under certain circumstances, requires Dee to repurchase the stock based on the book value of the net assets, plus an agreed amount for goodwill. At December 31, 1984, the buyout value of Taft’s stock is $675,000. Mr. Taft’s tax basis for his Dee stock is $430,000.

Mrs. Taft owns jewelry appraised on December 31, 1984, at $70,000 by an independent appraiser for insurance purposes. The jewelry, acquired by purchase and gift over a ten-year period, has a total tax basis of $40,000.

Liabilities

The Taft residence is encumbered by a mortgage which is payable in monthly installments of $1,000 through December 1990. Interest at 10% a year is included in the $1,000 monthly payment. The balance of the mortgage principal is $58,000 at December 31, 1984.

Mr. Taft has guaranteed the payment of loans of Dee Corporation under a $300,000 line of credit. The loan balance is $200,000 at December 31, 1984. Dee’s financial condition at December 31, 1984, is such that its repayment of the loan balance is reasonably assured.

57. In the Tafts’ December 31, 1984, personal statement of financial condition, the Dee Corporation investment and the jewelry should be reported at a total amount of
   a. $470,000
   b. $500,000
   c. $715,000
   d. $745,000

58. In the Tafts’ December 31, 1984, personal statement of financial condition, the liabilities listed above should be reported at a total amount of
   a. $58,000
   b. $72,000
   c. $258,000
   d. $272,000

---

AP-256
59. Evan, Inc., discloses supplemental industry segment information. The following data are available for 1984:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales</th>
<th>Traceable operating expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>E</td>
<td>$ 500,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>F</td>
<td>400,000</td>
<td>250,000</td>
</tr>
<tr>
<td>G</td>
<td>300,000</td>
<td>175,000</td>
</tr>
<tr>
<td></td>
<td>$1,200,000</td>
<td>$725,000</td>
</tr>
</tbody>
</table>

Additional 1984 expenses, not included above, are as follows:

- Indirect operating expenses: $180,000
- General corporate expenses: 120,000

Appropriate common expenses are allocated to segments based on the ratio of a segment's sales to total sales. What should be the operating profit for segment G for 1984?

- a. $125,000
- b. $ 80,000
- c. $ 65,000
- d. $ 50,000

60. Selected information from the accounting records of Kay Company is as follows:

- Net sales for 1984: $1,800,000
- Cost of goods sold for 1984: 1,200,000
- Inventory at 12/31/83: 360,000
- Inventory at 12/31/84: 312,000

Kay's inventory turnover for 1984 is

- a. 3.57 times.
- b. 3.85 times.
- c. 5.36 times.
- d. 5.77 times.

Number 4 (Estimated time —— 45 to 55 minutes)

Munn, Inc., had the following other noncurrent asset account balances at December 31, 1983:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patent</td>
<td>$192,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>(24,000)</td>
</tr>
<tr>
<td>Deferred income tax charges</td>
<td>36,000</td>
</tr>
</tbody>
</table>

Munn reports as other noncurrent assets any assets that are either intangible or not used directly in its operations.

Transactions during 1984 and other information relating to Munn’s other noncurrent assets were as follows:

- The patent was purchased from Grey Company for $192,000 on January 1, 1982, at which date the remaining legal life was 16 years. On January 1, 1984, Munn determined that the useful life of the patent was only eight years from the date of acquisition.

- Deferred income taxes are provided in recognition of timing differences between financial statement and income tax reporting of rent income and warranty expense. The rent received in advance and warranty liability are appropriately considered noncurrent items. For the year ended December 31, 1984: (1) rent collected in advance decreased by $20,000, and (2) product warranty liability increased by $15,000. Munn's income tax rate for 1984 was 40%.

- On January 3, 1984, in connection with the purchase of a trademark from Cody Corporation, the parties entered into a non-competition agreement and a consulting contract. Munn paid Cody $800,000, of which three-quarters was for the trademark, and one-quarter was for Cody's agreement not to compete for a five-year period in the line of business covered by the trademark. Munn considers the life of the trademark to be indefinite. Under the consulting contract, Munn agreed to pay Cody $50,000 annually on January 3 for five years. The first payment was made on January 3, 1984.

- On July 1, 1984, Munn purchased as a long-term investment $1,000,000 face value of Dell Corporation original issue 8% bonds for $923,000. The bonds, which were priced to yield 10%, pay interest semiannually on January 1 and July 1, and mature on July 1, 1989. Munn uses the interest method of amortization.

Required:

a. Prepare a schedule of the expenses for 1984 relating to Munn’s other noncurrent asset balances at December 31, 1983, and transactions during 1984. Include in the schedule the deferred income tax charge or credit portion of Munn’s total 1984 income tax expense.

b. Prepare the other noncurrent assets section of Munn’s balance sheet at December 31, 1984.
Number 5 (Estimated time —— 40 to 50 minutes)

Case, Inc., acquired all of the outstanding $25 par common stock of Frey, Inc., on June 30, 1984, in exchange for 40,000 shares of its $25 par common stock. The business combination meets all conditions for a pooling of interests. On June 30, 1984, Case’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, 1984, after year-end adjustments and closing nominal accounts, the companies had condensed balance sheet accounts as follows:

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Case</th>
<th>Frey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 825,000</td>
<td>$ 330,000</td>
</tr>
<tr>
<td>Accounts and other receivables</td>
<td>2,140,000</td>
<td>835,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>2,310,000</td>
<td>1,045,000</td>
</tr>
<tr>
<td>Land</td>
<td>650,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Depreciable assets, net</td>
<td>4,575,000</td>
<td>1,980,000</td>
</tr>
<tr>
<td>Investment in Frey, Inc.</td>
<td>2,430,000</td>
<td>—</td>
</tr>
<tr>
<td>Long-term investments and other assets</td>
<td>865,000</td>
<td>385,000</td>
</tr>
<tr>
<td><strong>Total assets:</strong></td>
<td><strong>$13,795,000</strong></td>
<td><strong>$4,875,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders’ Equity:</th>
<th>Case</th>
<th>Frey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and other current liabilities</td>
<td>$ 2,465,000</td>
<td>$1,145,000</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>1,900,000</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Common stock, $25 par value</td>
<td>3,200,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,850,000</td>
<td>190,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,380,000</td>
<td>1,240,000</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity:</strong></td>
<td><strong>$13,795,000</strong></td>
<td><strong>$4,875,000</strong></td>
</tr>
</tbody>
</table>

Additional information is as follows:

- Frey’s long-term debt consisted of 10% ten-year bonds issued at face value on March 31, 1978. Interest is payable semiannually on March 31 and September 30. Case had purchased Frey’s bonds at face value of $320,000 in 1978, and there was no change in ownership through December 31, 1984.

- During October 1984 Case sold merchandise to Frey at an aggregate invoice price of $720,000, which included a profit of $180,000. At December 31, 1984, one-half of the merchandise remained in Frey’s inventory, and Frey had not paid Case for the merchandise purchased.

- The 1984 net income amounts per the separate books of Case and Frey were $890,000 (exclusive of equity in Frey’s earnings) and $580,000, respectively.

- The balances in retained earnings at December 31, 1983, were $2,506,000 and $820,000 for Case and Frey, respectively.

**Required:**

Go to page 259 and remove tear-out worksheet.

- Complete the tear-out worksheet to prepare a consolidated balance sheet of Case, Inc., and its subsidiary, Frey, Inc., at December 31, 1984. 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.

- Prepare a formal consolidated statement of retained earnings for the year ended December 31, 1984.

AP-258
### Case, Inc. and Subsidiary

**CONSOLIDATED BALANCE SHEET WORKSHEET**

**December 31, 1984**

<table>
<thead>
<tr>
<th></th>
<th>Case, Inc.</th>
<th>Frey, Inc.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$825,000</td>
<td>$330,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts &amp; other receivables</td>
<td>2,140,000</td>
<td>835,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>2,310,000</td>
<td>1,045,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>650,000</td>
<td>300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciable assets, net</td>
<td>4,575,000</td>
<td>1,980,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Frey, Inc.</td>
<td>2,430,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term investments</td>
<td>865,000</td>
<td>385,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&amp; other assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets:</strong></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| **Liabilities and Stockholders' Equity:** |            |            |                            |              |
| Accounts payable & other current liabilities | $2,465,000  | $1,145,000 |                            |              |
| Long-term debt         | 1,900,000  | 1,300,000  |                            |              |
| Common stock, $25 par  | 3,200,000  | 1,000,000  |                            |              |
| Additional paid-in capital | 1,850,000    | 190,000    |                            |              |
| Retained earnings      | 4,380,000  | 1,240,000  |                            |              |
| **Total Liabilities & Stockholders' Equity:** | $13,795,000| $4,875,000 |                            |              |

AP-259
EXAMINATION IN ACCOUNTING PRACTICE — PART II

November 7, 1985; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>Question</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 1</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td>No. 2</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td>No. 3</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td>No. 4</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td>No. 5</td>
<td>40</td>
<td>50</td>
</tr>
<tr>
<td>Total</td>
<td>220</td>
<td>270</td>
</tr>
</tbody>
</table>

INSTRUCTIONS TO CANDIDATES

(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since 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.

3. Support all problem-type answers with properly labeled and legible calculations that can be identified as sources of amounts in formal schedules, entries, worksheets, or other answers, to show how your final answer was derived. Computation sheets should identify the question to which they relate, be placed immediately following the answer to that question, and be numbered in sequence with the other pages. Failure to enclose supporting calculations may result in loss of grading points because it may be impossible to determine how your amounts were computed.

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

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 — 45 to 55 minutes)

Instructions

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

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

Item

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

Answer Sheet

97.  a  c  d

Items to be Answered

1. Boa Corp. distributes service department overhead costs directly to producing departments without allocation to the other service department. Information for the month of June 1985 is as follows:

<table>
<thead>
<tr>
<th>Service Departments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Maintenance</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Utilities</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

   | Overhead costs       |
   |                     |
   | incurred             |
   |                      |
   | $20,000              |
   | $10,000              |

   | Service provided to |
   |                     |
   |                     |
   | departments:        |
   |                     |

   | Maintenance         |
   |                     |
   |                     |
   |                          |
   | Utilities              |
   |                          |
   | Producing — A         |
   |                        |
   | Producing — B         |
   |                        |
   | Totals                |
   |                        |
   |                          |

The amount of maintenance department costs distributed to Producing — A department for June 1985 was
   a. $8,000
   b. $8,800
   c. $10,000
   d. $11,000

Items 2 and 3 are based on the following data:

Blum Corp. manufactures plastic coated metal clips. The following were among Blum’s 1984 manufacturing costs:

<table>
<thead>
<tr>
<th>Wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine operators</td>
</tr>
<tr>
<td>Maintenance workers</td>
</tr>
<tr>
<td>Factory foremen</td>
</tr>
</tbody>
</table>

   |                         |
   | $200,000                 |
   | 30,000                   |
   | 90,000                   |

<table>
<thead>
<tr>
<th>Materials used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metal wire</td>
</tr>
<tr>
<td>Lubricant for oiling</td>
</tr>
<tr>
<td>Plastic coating</td>
</tr>
</tbody>
</table>

   |                         |
   | $500,000                 |
   | 10,000                   |
   | 380,000                  |

2. Blum’s 1984 direct labor amounted to
   a. $200,000
   b. $230,000
   c. $290,000
   d. $320,000

3. Blum’s 1984 direct materials amounted to
   a. $890,000
   b. $880,000
   c. $510,000
   d. $500,000

4. Tish Co. produces two joint products, Ebo and Gel. Joint production costs for May 1985 were $30,000. During May 1985 further processing costs beyond the split-off point, needed to convert the products into salable form, were $16,000 and $24,000 for 1,600 units of Ebo and 800 units of Gel, respectively. Ebo sells for $25 per unit and Gel sells for $50 per unit. Tish uses the net realizable value method for allocating joint product costs. What were the joint costs allocated to Ebo for May 1985?
   a. $10,000
   b. $12,000
   c. $18,000
   d. $20,000

5. In its July 1985 production, Gage Corp., which does not use a standard cost system, incurred total production costs of $800,000, of which Gage attributed $30,000 to normal spoilage and $20,000 to abnormal spoilage. Gage should account for this spoilage as
   a. Inventoriable cost of $30,000 and period cost of $20,000.
   b. Period cost of $30,000 and inventoriable cost of $20,000.
   c. Inventoriable cost of $50,000.
   d. Period cost of $50,000.
6. Lane Co. produces main products Kul and Wu. The process also yields by-product Zef. Net realizable value of by-product Zef is subtracted from joint production cost of Kul and Wu. The following information pertains to production in July 1985 at a joint cost of $54,000:

<table>
<thead>
<tr>
<th>Product</th>
<th>Units produced</th>
<th>Market value</th>
<th>Additional cost after split-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kul</td>
<td>1,000</td>
<td>$40,000</td>
<td>$0</td>
</tr>
<tr>
<td>Wu</td>
<td>1,500</td>
<td>35,000</td>
<td>0</td>
</tr>
<tr>
<td>Zef</td>
<td>500</td>
<td>7,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>

If Lane uses the net realizable value method for allocating joint cost, how much of the joint cost should be allocated to product Kul?

a. $18,800  
b. $20,000  
c. $26,667  
d. $27,342

---

Items 7 and 8 are based on the following data:

Apex Corp. is planning to buy production machinery costing $100,000. This machinery's expected useful life is five years, with no residual value. Apex requires a rate of return of 20%, and has calculated the following data pertaining to the purchase and operation of this machinery:

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated annual cash inflow</th>
<th>Present value of 1, at 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$60,000</td>
<td>20%</td>
</tr>
<tr>
<td>2</td>
<td>30,000</td>
<td>76%</td>
</tr>
<tr>
<td>3</td>
<td>20,000</td>
<td>63%</td>
</tr>
<tr>
<td>4</td>
<td>20,000</td>
<td>53%</td>
</tr>
<tr>
<td>5</td>
<td>20,000</td>
<td>44%</td>
</tr>
<tr>
<td>Totals</td>
<td>$150,000</td>
<td>3.27</td>
</tr>
</tbody>
</table>

Assuming that the cash inflow was received evenly during the year,

7. The payback period is
   a. 2.50 years.  
b. 2.75 years.  
c. 3.00 years.  
d. 5.00 years.

8. The net present value is
   a. $9,400  
b. $54,128  
c. $80,000  
d. $109,400

---

9. Information on Rex Co.'s direct material costs for May 1985 is as follows:

- Actual quantity of direct materials purchased and used: 30,000 lbs.
- Actual cost of direct materials: $84,000
- Unfavorable direct materials usage variance: $3,000
- Standard quantity of direct materials allowed for May production: 29,000 lbs.

For the month of May, what was Rex's direct materials price variance?

a. $2,800 favorable.  
b. $2,800 unfavorable.  
c. $6,000 unfavorable.  
d. $6,000 favorable.

---

Items 10 and 11 are based on the following data:

The following condensed balance sheet is presented for the partnership of Lever, Polen, and Quint, who share profits and losses in the ratio of 4:3:3, respectively:

<table>
<thead>
<tr>
<th></th>
<th>$90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>830,000</td>
</tr>
<tr>
<td>Lever, loan</td>
<td>20,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>210,000</td>
</tr>
<tr>
<td>Quint, loan</td>
<td>30,000</td>
</tr>
<tr>
<td>Lever, capital</td>
<td>310,000</td>
</tr>
<tr>
<td>Polen, capital</td>
<td>200,000</td>
</tr>
<tr>
<td>Quint, capital</td>
<td>190,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$940,000</td>
</tr>
</tbody>
</table>

10. Assume that the assets and liabilities are fairly valued on the balance sheet and that the partnership decides to admit Fahn as a new partner, with a 20% interest. No goodwill or bonus is to be recorded. How much should Fahn contribute in cash or other assets?

   a. $140,000  
b. $142,000  
c. $175,000  
d. $177,500

11. Assume that instead of admitting a new partner, the partners decide to liquidate the partnership. If the other assets are sold for $700,000, how much of the available cash should be distributed to Lever?

   a. $230,000  
b. $238,000  
c. $258,000  
d. $310,000
Items 12 through 16 are based on the following data:

**Beef Corporation**

**STOCKHOLDERS' EQUITY**

December 31, 1983

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $1 par value; authorized 3,000,000 shares; issued 1,500,000 shares; outstanding 1,400,000 shares</td>
<td>$1,400,000</td>
</tr>
<tr>
<td>Additional paid-in capital:</td>
<td></td>
</tr>
<tr>
<td>In excess of par</td>
<td>14,000,000</td>
</tr>
<tr>
<td>From treasury stock</td>
<td>200,000</td>
</tr>
<tr>
<td>Total paid-in capital</td>
<td>15,600,000</td>
</tr>
<tr>
<td>Unappropriated retained earnings</td>
<td>8,100,000</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>$23,700,000</td>
</tr>
</tbody>
</table>

All of the outstanding common stock and treasury stock were originally issued in 1981 for $11.00 per share. The treasury stock is common stock reacquired on March 31, 1983. Beef uses the par value method of accounting for treasury stock. During 1984 the following events or transactions occurred relating to Beef's stockholders' equity:

- February 12, 1984 — Issued 400,000 shares of unissued common stock for $12.50 per share.
- June 15, 1984 — Declared a cash dividend of $0.20 per share to stockholders of record on April 1, 1984, and payable on April 15, 1984. This was the first dividend ever declared by Beef.
- September 20, 1984 — Beef's president retired. Beef purchased from the retiring president 100,000 shares of Beef's common stock for $13.00 per share, which was equal to market value on this date. This stock was cancelled.
- December 15, 1984 — Declared a cash dividend of $0.20 per share to stockholders of record on January 2, 1985, and payable on January 15, 1985.
- At December 31, 1984, Beef is being sued by two separate parties for patent infringements. Beef's management and outside legal counsel share the following opinions regarding these suits:

<table>
<thead>
<tr>
<th>Suit</th>
<th>Likelihood of losing the suit</th>
<th>Estimated loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>#1</td>
<td>Reasonably possible</td>
<td>$600,000</td>
</tr>
<tr>
<td>#2</td>
<td>Probable</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

12. The issuance of 400,000 shares of common stock on February 12, 1984, caused Beef's additional paid-in capital in excess of par to increase by
   a. $0
   b. $400,000
   c. $4,600,000
   d. $5,000,000

13. The retirement of 100,000 shares of common stock on September 20, 1984, caused Beef's additional paid-in capital in excess of par to decrease by
   a. $0
   b. $100,000
   c. $1,000,000
   d. $1,200,000

14. Beef wants to appropriate retained earnings for all loss contingencies that are not properly accruable by a charge to expense. How much of Beef's loss contingencies should be appropriated by a charge to unappropriated retained earnings?
   a. $1,000,000
   b. $600,000
   c. $400,000
   d. $0

15. How much in cash dividends should Beef charge against unappropriated retained earnings in 1984?
   a. $700,000
   b. $680,000
   c. $360,000
   d. $340,000

16. How much should Beef show in notes to financial statements as a restriction on retained earnings because of the acquisition of treasury stock?
   a. $200,000
   b. $900,000
   c. $1,200,000
   d. $1,300,000

17. Platt Co. has been forced into bankruptcy and liquidated. Unsecured claims will be paid at the rate of 50¢ on the dollar. Maga Co. holds a non-interest bearing note receivable from Platt in the amount of $50,000, collateralized by machinery with a liquidation value of $10,000. The total amount to be realized by Maga on this note receivable is
   a. $35,000
   b. $30,000
   c. $25,000
   d. $10,000
Items 18 and 19 are based on the following data:

On January 1, 1984, Neel Corp. issued 400,000 additional shares of $10 par value common stock in exchange for all of Pym Corp.'s common stock. Immediately before this business combination, Neel's stockholders' equity was $16,000,000 and Pym's stockholders' equity was $8,000,000. On January 1, 1984, fair market value of Neel's common stock was $20 per share, and fair market value of Pym's net assets was $8,000,000. Neel's net income for the year ended December 31, 1984, exclusive of any consideration of Pym, was $2,500,000. Pym's net income for the year ended December 31, 1984, was $600,000. During 1984 Neel paid dividends of $900,000. Neel had no business transactions with Pym in 1984.

18. Assuming that this business combination is appropriately accounted for as a pooling of interests, consolidated stockholders' equity at December 31, 1984, should be
   a. $17,600,000
   b. $18,200,000
   c. $26,200,000
   d. $27,100,000

19. Assuming that this business combination is appropriately accounted for as a purchase, consolidated stockholders' equity at December 31, 1984, should be
   a. $17,600,000
   b. $18,200,000
   c. $26,200,000
   d. $27,100,000

20. Bye Co. is considering the sale of banners at the state university football championship game. Bye could purchase these banners for $0.60 each. Unsold banners would be nonreturnable and worthless after the game. Bye would have to rent a booth at the stadium for $250. Bye estimates sales of 500 banners at $2.00 each. If Bye's prediction proves to be incorrect and only 300 banners were sold, the cost of this prediction error would be
   a. $120
   b. $130
   c. $170
   d. $280

Number 2 (Estimated time —— 45 to 55 minutes)

Instructions

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

Items to be Answered

Items 21 and 22 are based on the following data:

Gary Barth, who is unmarried, owns a house which has been his principal residence for the past ten years. Gary wants to sell this house and move to a rental apartment. He has no intention of buying another residence at any time in the future, but wishes to avail himself of the one-time exclusion of gain on the sale of his house.

21. What is the minimum age Gary must attain in order to avail himself of the one-time exclusion of gain on sale of his house?
   a. 55
   b. 65
   c. 70
   d. 72

22. Assume that Gary has attained the required age to qualify for the one-time exclusion of gain on the sale of his house. What is the maximum amount allowable for this type of exclusion?
   a. 40% of long-term gain.
   b. 60% of long-term gain.
   c. $100,000.
   d. $125,000.

23. Leo Mann, a calendar-year taxpayer, filed his 1984 individual income tax return on March 15, 1985, and attached a check for the balance of tax due as shown on the return. On June 15, 1985, Leo discovered that he had failed to include, in his itemized deductions, $1,000 interest on his home mortgage. In order for Leo to recover the tax that he would have saved by utilizing the $1,000 deduction, he must file an amended return no later than
Uniform Certified Public Accountant Examination

Items 24 through 27 are based on the following data:

Amy Finch had the following cash receipts during 1984:

Interest on Veterans Administration insurance dividends left on deposit with the V.A.  $ 10
Interest on state income tax refund 18
Net rent on vacant lot used by a car dealer (lessee pays all taxes, insurance, and other expenses on the lot) 6,000
Advance rent from lessee of above vacant lot, such advance to be applied against rent for the last two months of the 5-year lease in 1988 1,000
Dividend from a mutual insurance company on a life insurance policy 500
Dividend on listed corporation stock; payment date by corporation was 12/30/83, but Amy received the dividend in the mail on 1/2/84 875

Gross amount of state lottery winnings (Amy spent $900 on state lottery tickets and $700 on pari-mutuel bets in 1984 at the state off-track betting parlor, for which she has full documentation) 2,400

Amy did not itemize her deductions on her 1984 return. Total dividends received to date on the life insurance policy do not exceed the aggregated premiums paid by Amy.

24. How much should Amy include in her 1984 taxable income for interest?
   a. $0
   b. $10
   c. $18
   d. $28

25. How much should Amy include in her 1984 taxable income for rent?
   a. $7,000
   b. $6,800
   c. $6,200
   d. $6,000

26. How much should Amy report for dividend income for 1984, before any applicable exclusions?
   a. $1,375
   b. $ 875
   c. $ 500
   d. $0

27. How much should Amy include in taxable “Other Income” for her 1984 state lottery winnings?
   a. $2,400
   b. $1,700
   c. $1,500
   d. $ 800

28. Neil and Lynn Barta are married and filed a joint 1984 return. For 1984, how much was the limit on capital losses that the Bartas could apply against other income after offsetting capital gains?
   a. $0
   b. $1,000
   c. $1,500
   d. $3,000

29. Fred Zorn died on January 5, 1985, bequeathing his entire $2,000,000 estate to his sister, Ida. The alternate valuation date was validly elected by the executor of Fred’s estate. Fred’s estate included 2,000 shares of a listed stock for which Fred’s basis was $380,000. This stock was distributed to Ida nine months after Fred’s death. Fair market values of this stock were:
   - At the date of Fred’s death: $400,000
   - Six months after Fred’s death: $450,000
   - Nine months after Fred’s death: $480,000

Ida’s basis for this stock is
   a. $380,000
   b. $400,000
   c. $450,000
   d. $480,000

30. Dan Olsen’s 1984 taxable income was $75,000. In computing his 1984 federal income tax, Dan was required to use the
   a. Tax Table only if he wanted to use income averaging.
   b. Tax Table even if he did not use income averaging.
   c. Tax Rate Schedule only if he wanted to use income averaging.
   d. Tax Rate Schedule even if he did not use income averaging.

31. With regard to alimony in connection with a 1985 divorce, which of the following statements is true?
   a. Alimony may be paid either in cash or in property.
   b. Alimony must terminate at the death of the payee spouse.
   c. The divorced couple may be members of the same household at the time alimony is paid.
   d. Alimony may be deductible by the payor spouse to the extent that payment is contingent on the status of the divorced couple’s child.
32. In January 1982, Kirk Kelly bought 100 shares of a listed stock for $8,000. In March 1983, when the fair market value was $6,000, Kirk gave this stock to his cousin, Clara. No gift tax was paid. Clara sold this stock in June 1985 for $7,000. How much is Clara’s reportable gain or loss in 1985 on the sale of this stock?
   a. $0.
   b. $1,000 loss.
   c. $1,000 gain.
   d. $7,000 gain.

33. For assets acquired in 1985, the holding period for determining long-term capital gains and losses is more than
   a. 18 months.
   b. 12 months.
   c. 9 months.
   d. 6 months.

Items 34 through 36 are based on the following data:

During 1984 Burt Knox made the following unreimbursed personal expenditures:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on note payable to a bank; proceeds of loan were used to buy municipal bonds</td>
<td>$1,000</td>
</tr>
<tr>
<td>Payments pertaining to condominium apartment occupied by Burt: Interest ($3,000) and principal ($2,200) on mortgage</td>
<td>$5,200</td>
</tr>
<tr>
<td>Realty taxes</td>
<td>$1,800</td>
</tr>
<tr>
<td>State and city gasoline taxes</td>
<td>$150</td>
</tr>
<tr>
<td>State hunting license fee</td>
<td>$25</td>
</tr>
<tr>
<td>Legal fee for preparation of will</td>
<td>$100</td>
</tr>
<tr>
<td>Education expenses to qualify for new occupation</td>
<td>$975</td>
</tr>
</tbody>
</table>

34. How much interest expense should be included in Burt’s 1984 itemized deductions?
   a. $6,200
   b. $5,200
   c. $4,000
   d. $3,000

35. How much should be included in Burt’s 1984 itemized deductions for taxes?
   a. $1,800
   b. $1,825
   c. $1,950
   d. $1,975

36. How much should be included in Burt’s 1984 itemized deductions for miscellaneous deductions?
   a. $1,075
   b. $975
   c. $100
   d. $0

37. Edgar Blair, who is single, did not claim any itemized deductions in his 1984 return because the deductions were less than Edgar’s zero bracket amount. In 1984 Edgar contributed $100 to the building fund of his state university. How much was deductible for contributions in Edgar’s 1984 return?
   a. $0
   b. $12.50
   c. $25.00
   d. $100.00

Items 38 and 39 are based on the following data:

Gene Blake, who is single, had an adjusted gross income of $50,000 in 1984. During 1984 Gene paid the following unreimbursed medical and dental expenses:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical insurance premiums</td>
<td>$300</td>
</tr>
<tr>
<td>Dental surgery</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Also in 1984, Gene suffered a $4,000 loss due to vandalism, for which Gene had no insurance. Gene itemized his deductions for 1984.

38. How much was deductible in Gene’s 1984 return for medical and dental expenses?
   a. $150
   b. $300
   c. $2,800
   d. $3,800

39. How much was deductible in Gene’s 1984 return as a casualty loss?
   a. $0
   b. $100
   c. $3,900
   d. $4,000

40. In 1984 Alan Kott provided more than half the support for his following relatives, none of whom qualified as a member of Alan’s household:

<table>
<thead>
<tr>
<th>Relative</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cousin</td>
<td></td>
</tr>
<tr>
<td>Niece</td>
<td></td>
</tr>
<tr>
<td>Foster parent</td>
<td></td>
</tr>
</tbody>
</table>

None of these relatives had any income, nor did any of these relatives file an individual or a joint return. All of these relatives are U.S. citizens. Which of these relatives could be claimed as a dependent on Alan’s 1984 return?
   a. No one.
   b. Niece.
   c. Cousin.
   d. Foster parent.
Number 3 (Estimated time — 45 to 55 minutes)

Instructions

Select the best answer for each of the following items relating to the federal income taxation of corporations and partnerships. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. 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. Mark only one answer for each item. Answer all items. Your grade will be based on the total number of your correct answers.

Items to be Answered

41. Poe Corp. was organized in 1985 with the intention of operating as an S corporation. What is the maximum number of stockholders allowable for eligibility as an S corporation?
   a. 5
   b. 15
   c. 25
   d. 35

42. If a calendar-year S corporation does not request an automatic six-month extension of time to file its income tax return, the return is due by
   a. January 31
   b. March 15
   c. April 15
   d. June 30

43. An S corporation is not permitted to take a deduction for
   a. Compensation of officers.
   b. Interest paid to individuals who are not stockholders of the S corporation.
   c. Charitable contributions.
   d. Employee benefit programs established for individuals who are not stockholders of the S corporation.

44. Cava Corp., which has no portfolio indebtedness, received the following dividends in 1984:
   From a mutual savings bank $1,500
   From an unaffiliated domestic taxable corporation 7,500
   How much of these dividends qualifies for the 85% dividends-received deduction?
   a. $9,000
   b. $7,500
   c. $1,500
   d. $0

45. Which of the following is a capital asset?
   a. Machinery used in manufacturing a product.
   b. Treasury stock.
   c. Goodwill.
   d. Real estate used in business operations.

46. During 1984 Ati Corp. had net long-term capital losses of $28,000, net short-term capital gains of $12,000, gains on the sale of Section 1231 property of $6,000, and losses on the sale of Section 1245 property of $8,000. There was no capital loss carryforward from prior years. How much was the capital gains deduction for 1984?
   a. $18,000
   b. $7,200
   c. $4,800
   d. $0

47. Thor Corporation's operating income for 1984 was $300,000, after consideration of $50,000 for charitable contributions. What was the maximum allowable deduction for contributions in Thor's 1984 return?
   a. $35,000
   b. $30,000
   c. $17,500
   d. $15,000

48. If a corporation's charitable contributions exceed the limitation for deductibility in a particular year, such excess
   a. Is not deductible in any future year.
   b. Becomes a carryover to a maximum of 5 succeeding years.
   c. May be carried back to the third preceding year.
   d. Reduces the corporation's capital loss carryback for that year.

49. In the reconciliation of income per books with income per return
   a. Only timing differences are considered.
   b. Only permanent differences are considered.
   c. Both timing and permanent differences are considered.
   d. Neither timing nor permanent differences are considered.

50. The filing of consolidated returns is available
   a. Only to parent-subsidiary corporations.
   b. Only to brother-sister corporations.
   c. Either to parent-subsidiary corporations or to brother-sister corporations.
   d. Neither to parent-subsidiary corporations nor to brother-sister corporations.

51. Of the following tax credits, which one is not available to corporations?
   a. Political contributions.
   b. Employee stock ownership.
   c. Alcohol fuel.
   d. Research.
52. The accumulated earnings tax does not apply to
   a. Corporations filing consolidated returns.
   b. Corporations that have preferred stock outstanding.
   c. Personal holding companies.
   d. Corporations that have more than 35 shareholders.

53. The personal holding company tax
   a. May be imposed regardless of the number of equal stockholders in a corporation.
   b. Should be self-assessed by filing a separate schedule with the regular tax return.
   c. May be imposed on both corporations and partnerships.
   d. Qualifies as a tax credit which may be used by partners or stockholders to reduce their individual income taxes.

54. When a parent corporation completely liquidates its 80%-owned subsidiary, the parent (as stockholder) will ordinarily
   a. Be subject to capital gains tax on 80% of the long-term gain.
   b. Be subject to capital gains tax on 100% of the long-term gain.
   c. Have to report any gain on liquidation as ordinary income.
   d. Not recognize gain or loss on the liquidating distributions.

55. Reproduced below are the 1984 corporate tax rates:

<table>
<thead>
<tr>
<th>Over—</th>
<th>But not over—</th>
<th>Of the amount over—</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$25,000</td>
<td>15%</td>
</tr>
<tr>
<td>$25,000</td>
<td>$50,000</td>
<td>$3,750 + 18%</td>
</tr>
<tr>
<td>$50,000</td>
<td>$75,000</td>
<td>$8,250 + 30%</td>
</tr>
<tr>
<td>$75,000</td>
<td>$100,000</td>
<td>$15,750 + 40%</td>
</tr>
<tr>
<td>$100,000</td>
<td>——</td>
<td>25,750 + 46%</td>
</tr>
</tbody>
</table>

Mason Corporation’s 1984 taxable income was $80,000.
Mason’s 1984 tax was
   a. $13,750
   b. $15,750
   c. $17,250
   d. $17,750

56. In computing the ordinary income of a partnership, a deduction is allowed for
   a. Guaranteed payments to partners.
   b. Short-term capital losses.
   c. The first $100 of dividends received from qualifying domestic corporations.
   d. Contributions to recognized charities.

57. A partner’s taxable income, arising from the partner’s interest in a partnership, includes
   a. Only the partner’s share of partnership income actually distributed to the partner during the year.
   b. The partner’s share of partnership income, whether or not distributed to the partner during the year.
   c. Only the partner’s salary actually paid to the partner during the year.
   d. Only the partner’s salary and interest paid to the partner during the year, and deducted by the partnership during that year.

58. In 1982, Lisa Bara acquired a one-third interest in Dee Associates, a partnership. In 1984, when Lisa’s entire interest in the partnership was liquidated, Dee’s assets consisted of the following: cash, $20,000; tangible property with a basis of $46,000 and a fair market value of $40,000. Dee had no liabilities. Lisa’s adjusted basis for her one-third interest was $22,000. Lisa received cash of $20,000 in liquidation of her entire interest. What was Lisa’s recognized loss in 1984 on the liquidation of her interest in Dee?
   a. $0.
   b. $2,000 short-term capital loss.
   c. $2,000 long-term capital loss.
   d. $2,000 ordinary loss.

59. A partnership is terminated for tax purposes
   a. Only when it has terminated under applicable local partnership law.
   b. When at least 50% of the total interest in partnership capital and profits changes hands by sale or exchange within 12 consecutive months.
   c. When the sale of partnership assets is made only to an outsider, and not to an existing partner.
   d. When the partnership return of income (Form 1065) ceases to be filed by the partnership.

60. For tax purposes, a retiring partner who receives retirement payments ceases to be regarded as a partner
   a. On the last day of the taxable year in which the partner retires.
   b. On the last day of the particular month in which the partner retires.
   c. The day on which the partner retires.
   d. Only after the partner’s entire interest in the partnership is liquidated.

AP-269
Presented below are the June 30, 1985 and 1984, balance sheets of Dorn Foundation, a nonprofit research and scientific organization:

## Dorn Foundation
### BALANCE SHEETS
#### June 30,

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$650,000</td>
<td>$630,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>744,000</td>
<td>712,000</td>
</tr>
<tr>
<td>Unbilled contract revenues and reimbursable grant expenses</td>
<td>976,000</td>
<td>780,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>80,000</td>
<td>76,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>2,450,000</td>
<td>2,198,000</td>
</tr>
<tr>
<td>Investments and endowment fund cash</td>
<td>840,000</td>
<td>780,000</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land and building</td>
<td>440,000</td>
<td>440,000</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>334,000</td>
<td>312,000</td>
</tr>
<tr>
<td>Leased property under capital leases</td>
<td>958,000</td>
<td>958,000</td>
</tr>
<tr>
<td>Total property, plant, and equipment</td>
<td>1,732,000</td>
<td>1,710,000</td>
</tr>
<tr>
<td>Less accumulated depreciation and amortization</td>
<td>518,000</td>
<td>370,000</td>
</tr>
<tr>
<td>Net property, plant, and equipment</td>
<td>1,214,000</td>
<td>1,340,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$4,504,000</td>
<td>$4,318,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liabilities and Fund Balances</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$836,000</td>
<td>$776,000</td>
</tr>
<tr>
<td>Restricted grant advances</td>
<td>522,000</td>
<td>420,000</td>
</tr>
<tr>
<td>Obligations under capital leases</td>
<td>176,000</td>
<td>164,000</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>1,534,000</td>
<td>1,360,000</td>
</tr>
<tr>
<td>Noncurrent capital lease obligations</td>
<td>618,000</td>
<td>794,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>2,152,000</td>
<td>2,154,000</td>
</tr>
<tr>
<td>Fund balances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrestricted</td>
<td>916,000</td>
<td>838,000</td>
</tr>
<tr>
<td>Net equity in property, plant, and equipment</td>
<td>596,000</td>
<td>546,000</td>
</tr>
<tr>
<td>Endowment</td>
<td>840,000</td>
<td>780,000</td>
</tr>
<tr>
<td>Total fund balances</td>
<td>2,352,000</td>
<td>2,164,000</td>
</tr>
<tr>
<td>Total liabilities and fund balances</td>
<td>$4,504,000</td>
<td>$4,318,000</td>
</tr>
</tbody>
</table>

Excerpts from Dorn Foundation’s Notes to Financial Statements follow:

**Revenue recognition** — Substantially all of the organization’s revenue is derived from restricted grants and cost-plus-fixed-fee contracts. Revenue is recognized based on the proportion of project expenses incurred to total anticipated project expenses (percentage-of-completion method). Losses on contracts are recognized when identified.
Fund balances — Of the $188,000 increase in fund balances from 1984 to 1985, $128,000 represents the results of current operating activities, and $60,000 represents capital additions from interest earned on endowment fund investments. The endowment fund, in the principal amount of $700,000, was received in 1982. The donor of this fund specified that principal and accumulated interest not be expended until 1990, at which time the fund, including accumulated interest, will be used for environmental research projects. Net equity in property, plant, and equipment is the carrying value of all property, plant, and equipment less related noncurrent liabilities to finance their acquisition. There were no dispositions of property, plant, and equipment during the year.

Lease commitments — The organization uses scientific equipment under capital leases expiring in 1991 which provide for the transfer of ownership of the equipment at the end of the lease term. The related future minimum lease payments as of June 30, 1985, for subsequent fiscal years, are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>$188,000</td>
</tr>
<tr>
<td>1987</td>
<td>188,000</td>
</tr>
<tr>
<td>1988</td>
<td>188,000</td>
</tr>
<tr>
<td>1989</td>
<td>188,000</td>
</tr>
<tr>
<td>1990</td>
<td>188,000</td>
</tr>
<tr>
<td>1991</td>
<td>20,000</td>
</tr>
<tr>
<td>Total</td>
<td>960,000</td>
</tr>
</tbody>
</table>

Less amount representing interest (166,000)

Present value of minimum lease payments $794,000

Required:
Prepare the statement of changes in financial position, including the schedule of changes in working capital, for the year ended June 30, 1985.
Number 5 (Estimated time — 40 to 50 minutes)

Leif Company is faced with the necessity of making the following three unrelated financial management decisions involving its Sigma Division:

a. Establishment of a selling price for a new product, called Kace, developed by Sigma. Kace’s variable cost is $3 per unit. The following probabilities of reaching annual sales levels for Kace have been estimated:

<table>
<thead>
<tr>
<th>Sales (in units)</th>
<th>If each unit is sold for</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$6</td>
</tr>
<tr>
<td>70,000</td>
<td>10%</td>
</tr>
<tr>
<td>80,000</td>
<td>50%</td>
</tr>
<tr>
<td>90,000</td>
<td>40%</td>
</tr>
</tbody>
</table>

b. Discontinuance of a currently produced product and acquisition of a new machine. Sigma’s manager, Baum, has recommended that an unprofitable product, called Sago, be discontinued, which would decrease Sigma’s current sales volume by 10%. In addition, Baum wants to improve efficiency by investing $100,000 in a new machine. Baum believes that implementation of his two recommendations would increase the pre-tax income rate on sales to 12%.

Sigma’s current rate of pre-tax income is 10% on annual sales of $2,000,000. Financing of these current annual sales requires an investment of $600,000. Leif measures Sigma’s performance by the pre-tax accounting rate of return on sales based on the initial investment.

c. Financing of a distributor. Cote Corp., which is one of Sigma’s distributors, wants to borrow $200,000 from Leif and to repay this loan within three years. As an inducement, Cote is offering Leif a participation in Cote’s income for three years. Payments by Cote at the end of each of the three years would include principal plus 5% of Cote’s net income for each of these years. The estimated amounts to be remitted by Cote to Leif under this arrangement would be as follows:

At the end of year | Amount |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>2</td>
<td>90,000</td>
</tr>
<tr>
<td>3</td>
<td>110,000</td>
</tr>
</tbody>
</table>

Total estimated remittances $250,000

Leif would be willing to grant Cote’s loan request if the annual pre-tax internal rate of return on this loan exceeds Leif’s hurdle (discount) rate of 20% on investment. Present value factors yielding 20% are approximately:

<table>
<thead>
<tr>
<th>Year</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.8</td>
</tr>
<tr>
<td>2</td>
<td>.7</td>
</tr>
<tr>
<td>3</td>
<td>.6</td>
</tr>
</tbody>
</table>

Required:

a. As a guide to Leif Company in determining a selling price for Kace, prepare a schedule of the expected annual contribution margin for each of the sales prices proposed for Kace.

b. 1. Compute Leif Company’s current pre-tax accounting rate of return on its investment in Sigma Division.

2. Compute Leif Company’s expected pre-tax accounting rate of return on its proposed investment in Sigma Division if Baum’s two recommendations are implemented.

c. Regarding the possible financing of Cote Corp. by Leif Company, compute the net present value of Leif Company’s investment opportunity on the proposed loan to Cote Corp., and state whether the investment would earn Leif a minimum internal rate of return of 20%.
ANSWERS TO EXAMINATION

ACCOUNTING PRACTICE — PART I

November 6, 1985; 1:30 to 6:00 P.M.

<table>
<thead>
<tr>
<th>Answer 1 (10 points)</th>
<th>Answer 2 (10 points)</th>
<th>Answer 3 (10 points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. c</td>
<td>11. a</td>
<td>21. a</td>
</tr>
<tr>
<td>2. d</td>
<td>12. d</td>
<td>22. d</td>
</tr>
<tr>
<td>3. c</td>
<td>13. d</td>
<td>23. b</td>
</tr>
<tr>
<td>4. b</td>
<td>14. c</td>
<td>24. c</td>
</tr>
<tr>
<td>5. b</td>
<td>15. b</td>
<td>25. a</td>
</tr>
<tr>
<td>6. b</td>
<td>16. d</td>
<td>26. b</td>
</tr>
<tr>
<td>7. b</td>
<td>17. c</td>
<td>27. a</td>
</tr>
<tr>
<td>8. c</td>
<td>18. c</td>
<td>28. d</td>
</tr>
<tr>
<td>9. c</td>
<td>19. b</td>
<td>29. b</td>
</tr>
<tr>
<td>10. a</td>
<td>20. a</td>
<td>30. a</td>
</tr>
</tbody>
</table>

The scores for the multiple choice questions were determined in accordance with the following scales:

### Answer 1

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0</td>
<td>½</td>
<td>1</td>
<td>1½</td>
<td>2</td>
<td>2½</td>
<td>3</td>
<td>3½</td>
<td>4</td>
<td>4½</td>
<td>5</td>
<td>5½</td>
<td>6</td>
<td>6½</td>
<td>7</td>
<td>7½</td>
<td>8</td>
<td>8½</td>
<td>9</td>
<td>9½</td>
<td>10</td>
</tr>
</tbody>
</table>

### Answer 2

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0</td>
<td>1</td>
<td>1½</td>
<td>2</td>
<td>2½</td>
<td>3</td>
<td>3½</td>
<td>4</td>
<td>4½</td>
<td>5</td>
<td>5½</td>
<td>6</td>
<td>6½</td>
<td>7</td>
<td>7½</td>
<td>8</td>
<td>8½</td>
<td>9</td>
<td>9½</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

### Answer 3

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0</td>
<td>1½</td>
<td>2</td>
<td>2½</td>
<td>3</td>
<td>3½</td>
<td>4</td>
<td>4½</td>
<td>5</td>
<td>5½</td>
<td>6</td>
<td>6½</td>
<td>7</td>
<td>7½</td>
<td>8</td>
<td>8½</td>
<td>9</td>
<td>9½</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>
**Munn, Inc.**

**SCHEDULE OF EXPENSES RELATING TO OTHER NONCURRENT ASSETS**

*For the Year Ended December 31, 1984*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization of intangibles</td>
<td></td>
</tr>
<tr>
<td>Patent</td>
<td>$28,000</td>
</tr>
<tr>
<td>Trademark</td>
<td>15,000</td>
</tr>
<tr>
<td>Non-competition agreement</td>
<td>40,000</td>
</tr>
<tr>
<td>Total</td>
<td>$83,000</td>
</tr>
<tr>
<td>Consulting fee to Cody Corporation</td>
<td>$50,000</td>
</tr>
<tr>
<td>Deferred income tax expense</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

**Munn, Inc.**

**OTHER NONCURRENT ASSETS SECTION OF BALANCE SHEET**

*December 31, 1984*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in bonds</td>
<td>$929,150</td>
</tr>
<tr>
<td>Patent, net of accumulated amortization of $52,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Trademark, net of accumulated amortization of $15,000</td>
<td>585,000</td>
</tr>
<tr>
<td>Non-competition agreement, net of accumulated amortization of $40,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Deferred income tax charges</td>
<td>34,000</td>
</tr>
<tr>
<td>Total other noncurrent assets</td>
<td>$1,848,150</td>
</tr>
</tbody>
</table>
Answer 4 (continued)

Explanations of Amounts

[1] Amortization of patent
Patent balance, 12/31/83 ($192,000 – $24,000) $ 168,000
Life of patent (6 years from 12/31/83) + 6
Amortization for 1984 $ 28,000

[2] Amortization of trademark
Cost of trademark, 1/3/84 ($800,000 x ¾) $ 600,000
Life of trademark (maximum 40 years) + 40
Amortization for 1984 $ 15,000

[3] Amortization of non-competition agreement
Cost of non-competition agreement, 1/3/84 ($800,000 x ¼) $ 200,000
Life of agreement (5 years) + 5
Amortization for 1984 $ 40,000

[4] Deferred income tax expense
Timing differences for 1984
Excess of book rent income over tax rent income of $20,000 x 40% $ 8,000
Deduct excess of book warranty expense over tax warranty deduction of $15,000 x 40% 6,000
Net expense for 1984 $ 2,000

[5] Investment in bonds
Cost of bonds, 7/1/84 $ 923,000
Add amortization of discount from 7/1 to 12/31/84 ($46,150 – $40,000) 6,150
Balance, 12/31/84 $ 929,150

Cost of patent, 1/1/82 $ 192,000
Deduct accumulated amortization, 12/31/83 24,000
Patent balance, 12/31/83 $ 168,000
Deduct amortization for 1984 28,000 [1]
Balance, 12/31/84 $ 140,000

[7] Trademark, net of accumulated amortization
Cost of trademark, 1/3/84 $ 600,000 [2]
Deduct amortization for 1984 $ 15,000 [2]
Balance, 12/31/84 $ 585,000

[8] Non-competition agreement, net of accumulated amortization
Cost of non-competition agreement, 1/3/84 $ 200,000 [3]
Deduct amortization for 1984 40,000 [3]
Balance, 12/31/84 $ 160,000

[9] Deferred income tax charges
Balance, 12/31/83 $ 36,000
Deduct charge to expense for 1984 2,000 [4]
Balance, 12/31/84 $ 34,000
### CONSOLIDATED BALANCE SHEET WORKSHEET

**December 31, 1984**

<table>
<thead>
<tr>
<th></th>
<th>Case, Inc.</th>
<th>Frey, Inc.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$825,000</td>
<td>$330,000</td>
<td>[3]$8,000</td>
<td>$1,155,000</td>
</tr>
<tr>
<td>Accounts &amp; other receivables</td>
<td>2,140,000</td>
<td>835,000</td>
<td>[4]720,000</td>
<td>2,247,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>2,310,000</td>
<td>1,045,000</td>
<td>[5]90,000</td>
<td>3,265,000</td>
</tr>
<tr>
<td>Land</td>
<td>650,000</td>
<td>300,000</td>
<td></td>
<td>950,000</td>
</tr>
<tr>
<td>Depreciable assets, net</td>
<td>4,575,000</td>
<td>1,980,000</td>
<td>[1]2,430,000</td>
<td>6,555,000</td>
</tr>
<tr>
<td>Investment in Frey, Inc.</td>
<td>2,430,000</td>
<td></td>
<td></td>
<td>2,430,000</td>
</tr>
<tr>
<td>Long-term investments &amp; other assets</td>
<td>865,000</td>
<td>385,000</td>
<td>[2]320,000</td>
<td>930,000</td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td>$15,102,000</td>
</tr>
<tr>
<td><strong>Liabilities and Stockholders' Equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable &amp; other current liabilities</td>
<td>$2,465,000</td>
<td>$1,145,000</td>
<td>[3]$8,000</td>
<td>$2,882,000</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>1,900,000</td>
<td>1,300,000</td>
<td>[2]320,000</td>
<td>2,880,000</td>
</tr>
<tr>
<td>Common stock, $25 par</td>
<td>3,200,000</td>
<td>1,000,000</td>
<td>[1]1,000,000</td>
<td>3,200,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,850,000</td>
<td>190,000</td>
<td>[1]190,000</td>
<td>1,850,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,380,000</td>
<td>1,240,000</td>
<td>[1]1,240,000</td>
<td>4,290,000</td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td>$3,568,000</td>
<td>$15,102,000</td>
</tr>
</tbody>
</table>
**Answer 5 (continued)**

**b. Case, Inc. and Subsidiary**

**CONSOLIDATED STATEMENT OF RETAINED EARNINGS**

*For the Year Ended December 31, 1984*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 1983:</td>
<td></td>
</tr>
<tr>
<td>As originally reported</td>
<td>$2,506,000</td>
</tr>
<tr>
<td>Adjustment for pooling of interests with Frey, Inc.</td>
<td>820,000</td>
</tr>
<tr>
<td>As restated</td>
<td>3,326,000</td>
</tr>
<tr>
<td>Net income</td>
<td>1,380,000 [6]</td>
</tr>
<tr>
<td></td>
<td>4,706,000</td>
</tr>
</tbody>
</table>

Deduct cash dividends paid:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>By Frey, Inc., prior to combination</td>
<td>160,000 [7]</td>
</tr>
<tr>
<td>By Case, Inc., after the combination</td>
<td>256,000</td>
</tr>
<tr>
<td></td>
<td>416,000</td>
</tr>
</tbody>
</table>

Balance, December 31, 1984  

$4,290,000

**Explanations of Worksheet Entries & Other Amounts**

[1] To eliminate the reciprocal elements in investment and equity accounts.


[3] To eliminate Case’s intercompany accrued interest receivable on its investment in Frey’s bonds for the period 10/1 — 12/31/84. ($320,000 x 10% x ¼ = $8,000)


[5] To eliminate intercompany profit in ending inventory of Frey. ($180,000 x ½ = $90,000)


Case, Inc.  

$890,000

Frey, Inc.  

580,000

Deduct intercompany profit in inventory  

90,000 [5]  

$1,380,000

[7] Dividend paid 6/15/84  

[40,000 shares x $4]  

$160,000
ANSWERS TO EXAMINATION

ACCOUNTING PRACTICE — PART II

November 7, 1985; 1:30 to 6:00 P.M.

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Answer 4 (10 points)

Dorn Foundation
STATEMENT OF CHANGES IN FINANCIAL POSITION
For the Year Ended June 30, 1985

Financial resources were provided by
Excess of revenues over expenses before capital additions $128,000
Capital additions 60,000
Excess of revenues over expenses after capital additions 188,000
Add expenses not requiring current outlay
of working capital — depreciation and amortization 148,000
Working capital provided by operations
and capital additions 336,000

Financial resources were used for
Acquisition of property, plant, and equipment 22,000
Reduction of noncurrent capital lease obligations 176,000
Increase in noncurrent investments and endowment fund cash 60,000
Total resources used 258,000
Increase in working capital $ 78,000

Changes in working capital were represented by
Increase in current assets
Cash $ 20,000
Accounts receivable 32,000
Unbilled contract revenues and reimbursable grant expenses 196,000
Prepaid expenses 4,000
Total increase in current assets 252,000

(Increase) in current liabilities
Accounts payable ( 60,000)
Restricted grant advances (102,000)
Obligations under capital leases ( 12,000)
Total (increase) in current liabilities (174,000)
Increase in working capital $ 78,000
Answer 5 (10 points)

a.  
Leif Company  
Sigma Division

SCHEDULE OF EXPECTED ANNUAL CONTRIBUTION MARGIN  
FOR RACE AT VARIOUS SALES PRICES

<table>
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<tr>
<th>Sales price</th>
<th>Expected sales level (units)</th>
<th>Expected total sales</th>
<th>Expected variable costs at $3</th>
<th>Expected contribution margin</th>
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<td>$6</td>
<td>83,000 [1]</td>
<td>$498,000</td>
<td>$249,000</td>
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<tr>
<td>7</td>
<td>79,000 [2]</td>
<td>553,000</td>
<td>237,000</td>
<td>316,000</td>
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<tr>
<td>8</td>
<td>74,000 [3]</td>
<td>592,000</td>
<td>222,000</td>
<td>370,000</td>
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</table>

[1] 70,000 × 10% = 7,000  
[2] 70,000 × 40% = 28,000  
[3] 70,000 × 70% = 49,000

80,000 × 50% = 40,000  
80,000 × 30% = 24,000  
90,000 × 10% = 9,000

70,000 × 40% = 36,000  
90,000 × 30% = 27,000

83,000  
79,000  
74,000

b.

1. COMPUTATION OF CURRENT PRE-TAX ACCOUNTING RATE OF RETURN ON INVESTMENT

Sigma Division’s current annual sales  
$2,000,000  
Current pre-tax rate of return on sales  
10%  
$200,000

Investment in Sigma Division  
600,000

Pre-tax accounting rate of return on investment  
33 1/3%

b.

2. COMPUTATION OF EXPECTED PRE-TAX ACCOUNTING RATE OF RETURN ON IMPLEMENTATION OF RECOMMENDATIONS BY MANAGER OF SIGMA DIVISION

Sigma Division’s current annual sales  
$2,000,000  
Expected reduction in sales volume (10%)  
200,000

Expected sales volume after discontinuance of Sago  
1,800,000

Expected pre-tax accounting rate of return on sales  
12%  
$216,000

Total proposed investment in  
Sigma Division  
700,000

Expected pre-tax accounting rate of return on investment  
30.86%

c.

COMPUTATION OF NET PRESENT VALUE OF INVESTMENT OPPORTUNITY ON PROPOSED LOAN TO COTE CORP.

Discounted cash flows for year:

1.  
.8 × $50,000 = $40,000

2.  
.7 × 90,000 = 63,000

3.  
.6 × 110,000 = 66,000

Total  
$169,000

Proposed loan  
200,000

Net present value  
$(31,000)

This investment will not earn an internal rate of return of 20%.
SUGGESTED REFERENCES
November 1985

Accounting Practice — Part I

Number 1, 2 and 3

Danos and Imhoff, Intermediate Accounting (Prentice-Hall, 1983).
FASB, Accounting Standards, Current Text (FASB).
FASB, Financial Accounting Standards, Original Pronouncements (FASB).
Griffin, Williams, and Larson, Advanced Accounting, 4th ed. (Irwin, 1980).
Smith and Skousen, Intermediate Accounting, comp. vol., 8th ed. (South-Western, 1984).
Welsch, Zlatkovich, and Harrison, Intermediate Accounting, 6th ed. (Irwin, 1982).

Number 4

AICPA, Accounting Principles Board Opinion no. 11, Accounting for Income Taxes (AICPA, 1967).
AICPA, Accounting Principles Board Opinion no. 20, Accounting Changes (AICPA, 1971).

Number 5


Accounting Practice — Part II

Number 1

Drebin, Advanced Accounting, 5th ed. (South-Western, 1982).
FASB, Accounting Standards: Current Text (FASB).
Fischer, Taylor, and Leer, Advanced Accounting, 2d ed. (South-Western, 1982).
Shillinglaw, Managerial Cost Accounting, 5th ed. (Irwin, 1982).
Welsch, Zlatkovich, and Harrison, Intermediate Accounting, 6th ed. (Irwin, 1982).

Number 4


Number 5

Matz and Usry, Cost Accounting Planning and Control, 8th ed. (South-Western, 1984), pp. 669-674, 747-753.
INDEX — QUESTIONS

HOW TO USE THIS INDEX: This index presents examination question number references according to the areas and groups within the Accounting Practice Content Specification Outline. The Appendix located at the back of this book contains the content specification outlines for the four sections of the CPA examination.

The question references listed in the right hand column are designated as follows: The question numbers are followed by the page number (in parentheses) in this book. The letter M following question numbers indicates a multiple choice item. For example, the reference 17M(AP-250) means multiple choice item number 17 on page AP-250; the reference 5(AP-258) means essay or problem number 5 on page AP-258. Note that no distinction has been made between Accounting Practice, Parts I and II.

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I. Presentation of Financial Statements or Worksheets.

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B. Income Statement ..................................................4(AP-257)
C. Statement of Changes in Financial Position ..........
D. Statement of Owners’ Equity .............................
E. Consolidated Financial Statements or Worksheets .....5(AP-258)

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D. Capitalized Lease Liability ....................................23M(AP-251)
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IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles.

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C. Retained Earnings and Dividends ..........................14M(AP-264),15M(AP-264)
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F. Reorganization and Change In Entity ........................17M(AP-264),18M(AP-265),19M(AP-265)
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D. Recurring Versus Nonrecurring Transactions and Events ..................................................48M(AP-255)

E. Accounting Changes ......................................................49M(AP-255), 50M(AP-255)

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B. Accounting Policies ..........................................................

C. Nonmonetary Transactions ............................................41M(AP-254)

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G. Segments and Lines of Business ....................................59M(AP-257)

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C. Standard Costing ..........................................................

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap ........................................4M(AP-262), 5M(AP-262), 6M(AP-263)

E. Absorption and Variable Costing ............................

F. Budgeting and Flexible Budgeting ................................5(AP-272)

G. Breakeven and Cost-Volume-Profit Analysis ...........5(AP-272)

H. Capital Budgeting Techniques .................................7M(AP-263), 8M(AP-263), 5(AP-272)

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Accounting Theory

Selected Questions
And Unofficial Answers
Indexed To
Content Specification
Outline

edited by
James D. Blum
Assistant Director, Examinations Division
Charles A. Rhuda
Technical Manager, Examinations Division
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<td>B. Deferred Revenues</td>
<td>*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Deferred Income Tax Liabilities</td>
<td>T-12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Capitalized Lease Liability</td>
<td>T-13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Bonds Payable</td>
<td>T-13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Contingent Liabilities and Commitments</td>
<td>T-14</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Preferred and Common Stock</td>
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<td></td>
<td>T-59†</td>
</tr>
<tr>
<td>B. Additional Paid-in Capital</td>
<td>T-16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Retained Earnings and Dividends</td>
<td>T-16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Treasury Stock and Other Contra Accounts</td>
<td>T-17</td>
<td></td>
<td></td>
</tr>
<tr>
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<td>T-18</td>
<td></td>
<td>*</td>
</tr>
<tr>
<td>F. Reorganization and Change in Entity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>G. Partnerships</td>
<td>T-19</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Revenues and Gains</td>
<td>T-19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Expenses and Losses</td>
<td>T-20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Provision for Income Tax</td>
<td>T-23</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*No multiple choice items/problems were indexed for this group.

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

D. Recurring Versus Nonrecurring Transactions and Events
E. Accounting Changes
F. Earnings Per Share

VI. Other Financial Topics

A. Statement of Changes in Financial Position
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

A. Nature of Cost Elements
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
I. Performance Analysis
J. Other

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework
B. Fund Accounting
C. Types of Funds and Fund Accounts
D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
E. Various Types of Not-for-Profit and Governmental Organizations

Selected Multiple Choice Items — Unofficial Answers

Essays — Selected Questions

Selected Essays — Unofficial Answers

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Suggested References

Index — Content Specification Outline
MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

B. Conceptual Framework

M85#1. Under Statement of Financial Accounting Concepts No. 2, representational faithfulness is an ingredient of

<table>
<thead>
<tr>
<th>Relevance</th>
<th>Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#1. Under Statement of Financial Accounting Concepts No. 2, which of the following relates to both relevance and reliability?

a. Timeliness.
b. Materiality.
c. Verifiability.
d. Neutrality.

N83#1. Under Statement of Financial Accounting Concepts No. 3, the term recognized is synonymous with the term

a. Recorded.
b. Realized.
c. Matched.
d. Allocated.

M83#1. Under Statement of Financial Accounting Concepts No. 2, feedback value is an ingredient of the primary quality of

<table>
<thead>
<tr>
<th>Relevance</th>
<th>Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M84#2. Under Statement of Financial Accounting Concepts No. 3, comprehensive income includes changes in equity resulting from

<table>
<thead>
<tr>
<th>Investments by owners</th>
<th>Distributions to owners</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M83#2. Under Statement of Financial Accounting Concepts No. 3, comprehensive income includes which of the following?

<table>
<thead>
<tr>
<th>Losses</th>
<th>Contribution margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N84#2. Under Statement of Financial Accounting Concepts No. 3, which of the following, in the most precise sense, means the process of converting noncash resources and rights into cash or claims to cash?

a. Allocation.
b. Recordation.
c. Recognition.
d. Realization.

N84#1. Under Statement of Financial Accounting Concepts No. 2, which of the following relates to both relevance and reliability?

a. Timeliness.
b. Materiality.
c. Verifiability.
d. Neutrality.
M83#2. Under Statement of Financial Accounting Concepts No. 2, which of the following interacts with both relevance and reliability to contribute to the usefulness of information?

<table>
<thead>
<tr>
<th></th>
<th>Predictive value</th>
<th>Feedback value</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M83#3. Under Statement of Financial Accounting Concepts No. 3, interrelated elements that are directly related to measuring performance and status of an enterprise include

<table>
<thead>
<tr>
<th>Distribution to owners</th>
<th>Notes to financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M83#4. Under Statement of Financial Accounting Concepts No. 3, gains on assets unsold are identified, in a precise sense, by the term

a. Unrecorded.
b. Unrealized.
c. Unrecognized.
d. Unallocated.

M82#15. According to Statement of Financial Accounting Concepts No. 2, an interim earnings report is expected to have which of the following?

<table>
<thead>
<tr>
<th>Predictive value</th>
<th>Feedback value</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M82#33. According to Statement of Financial Accounting Concepts No. 2, relevance and reliability are the two primary qualities that make accounting information useful for decision making. Predictive value is an ingredient of

<table>
<thead>
<tr>
<th>Relevance</th>
<th>Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M81#2. The information provided by financial reporting pertains to

a. Individual business enterprises, rather than to industries or an economy as a whole or to members of society as consumers.
b. Individual business enterprises and industries, rather than to an economy as a whole or to members of society as consumers.
c. Individual business enterprises and an economy as a whole, rather than to industries or to members of society as consumers.
d. Individual business enterprises, industries, and an economy as a whole, rather than to members of society as consumers.

M81#11. Financial reporting provides information about an enterprise's performance during a period when it was under the direction of a particular management

a. But does not directly provide information about that management's performance.
b. And directly provides information about that management's performance.
c. And directly provides information about both management performance and enterprise performance.
d. And directly provides estimates of an enterprise's earning power.

C. Basic Concepts and Accounting Principles

M85#2. Some costs cannot be directly related to particular revenues but are incurred to obtain benefits that are exhausted in the period in which the costs are incurred. An example of such a cost is

a. Salespersons' monthly salaries.
b. Salespersons' commissions.
c. Transportation to customers.
d. Prepaid insurance.
Selected Questions

N84#3. Simultaneous recognition of both a revenue and an expense may result from certain transactions or events. An example of an expense so recognized may be
a. Expired portion of prepaid insurance.
b. Salesperson's monthly salaries.
c. Transportation to customers.
d. Electricity used to light offices.

N84#4. Recognizing depletion expense is an example of the accounting process of

<table>
<thead>
<tr>
<th>Allocation</th>
<th>Amortization</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N84#3. A patent, purchased in 1981 and being amortized over a ten-year life, was determined to be worthless in 1984. The write-off of the asset in 1984 is an example of which of the following principles?

a. Associating cause and effect.
b. Systematic and rational allocation.
c. Immediate recognition.
d. Objectivity.

N83#3. Some costs cannot be directly related to particular revenues but are incurred to obtain benefits in the period in which the costs are incurred. An example of such a cost is
a. Electricity used to light offices.
b. Transportation to customers.
c. Cost of merchandise sold.
d. Sales commissions.

N83#5. Which of the following is expensed under the principle of systematic and rational allocation?

a. Salesmen's monthly salaries.
b. Insurance premiums.
c. Transportation to customers.
d. Electricity to light office building.

M82#16. Uncertainty and risks inherent in business situations should be adequately considered in financial reporting. This statement is an example of the concept of
a. Conservatism.
b. Completeness.
c. Neutrality.
d. Representational faithfulness.

N81#3. Which of the following is an application of the principle of systematic and rational allocation?

a. Amortization of intangible assets.
b. Sales commissions.
c. Research and development costs.
d. Officers' salaries.

N81#5. The accrued balance in a revenue account represents an amount which is

<table>
<thead>
<tr>
<th>Earned</th>
<th>Collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M81#2. The valuation of a promise to receive cash in the future at present value on the financial statements of a business entity is valid because of the accounting concept of

a. Entity.
b. Materiality.
c. Going concern.
d. Neutrality.

M81#3. Which of the following is an example of the expense recognition principle of associating cause and effect?

a. Allocation of insurance cost.
b. Sales commissions.
c. Depreciation of fixed assets.
d. Officers' salaries.

M81#4. Accruing net losses on firm purchase commitments for inventory is an example of the accounting concept of

a. Conservatism.
b. Realization.
c. Consistency.
d. Materiality.

M81#5. Which of the following accounting concepts states that an accounting transaction should be supported by sufficient evidence to allow two or more qualified individuals to arrive at essentially similar measures and conclusions?

a. Matching.
b. Objectivity.
c. Periodicity.
d. Stable monetary unit.

E. Consolidated Financial Statements

N84#5. A subsidiary, acquired for cash in a business combination, owned equipment with a market value in excess of book value as of the date of combination. A
consolidated balance sheet prepared immediately after the acquisition would treat this excess as
a. Goodwill.
b. Plant and equipment.
c. Retained earnings.
d. Deferred credits.

N82#2. How would the retained earnings of a subsidiary acquired in a business combination usually be treated in a consolidated balance sheet prepared immediately after the acquisition?
   a. Excluded for both a purchase and a pooling of interests.
b. Excluded for a pooling of interests but included for a purchase.
c. Included for both a purchase and a pooling of interests.
d. Included for a pooling of interests but excluded for a purchase.

N82#4. Consolidated financial statements are typically prepared when one company has
a. Accounted for its investment in another company by the equity method.
b. Accounted for its investment in another company by the cost method.
c. Significant influence over the operating and financial policies of another company.
d. The controlling financial interest in another company.

M82#12. A subsidiary may be acquired by issuing common stock in a pooling of interests transaction or by paying cash in a purchase transaction. Which of the following items would be reported in the consolidated financial statements at the same amount regardless of the accounting method used?
   a. Minority interest.
b. Goodwill.
c. Retained earnings.
d. Capital stock.

M82#18. Ownership of 51 percent of the outstanding voting stock of a company would usually result in
a. The use of the cost method.
b. The use of the lower of cost or market method.
c. A pooling of interests.
d. A consolidation.

F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

M85#3. When computing information on a historical cost/constant dollar basis, which of the following is classified as nonmonetary?
   a. Accumulated depreciation of equipment.
b. Advances to unconsolidated subsidiaries.
c. Allowance for doubtful accounts.
d. Unamortized premium on bonds payable.

M84#8. When computing information on a historical cost/constant dollar basis, which of the following is classified as monetary?
   a. Goodwill arising from a business combination concluded last year.
b. Deferred investment tax credits related to equipment.
c. Obligation under warranties expiring in one year.
d. Allowance for doubtful accounts on long-term receivables.

M84#7. During a period of inflation, an account balance remains constant. With respect to this account, a purchasing power loss will be recognized if the account is a
   a. Monetary asset.
b. Monetary liability.
c. Nonmonetary asset.
d. Nonmonetary liability.

M84#4. When measuring the current cost of inventories in accordance with FASB Statement No. 33, the "exit" date can mean the

<table>
<thead>
<tr>
<th>End of year</th>
<th>Date of sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
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<tr>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#5. When computing information on a historical cost/constant dollar basis, which of the following is classified as nonmonetary?
   a. Deferred income tax credits.
b. Long-term receivables.
c. Goodwill.
d. Unamortized premium on bonds payable.

M83#4. When computing information on a historical cost/constant dollar basis, which of the following is classified as monetary?
   a. Equity investment in unconsolidated subsidiaries.
b. Obligations under warranties.
c. Unamortized discount on bonds payable.
d. Deferred investment tax credits.

M83#7. A method of accounting based on measures of current cost or lower recoverable amount, without restatement into units having the same general purchasing power, is
   a. Historical cost/constant dollar accounting.
b. Historical cost/nominal dollar accounting.
Selected Questions

N82#3. In accordance with FASB Statement No. 33, the Consumer Price Index for All Urban Consumers is used to compute information on a
a. Historical cost basis.
b. Current cost basis.
c. Constant dollar basis.
d. Nominal dollar basis.

N82#33. When computing information on a historical cost/constant dollar basis, which of the following is classified as monetary?
   a. Obligations under warranties.
   b. Inventories, other than inventories used on contracts.
   c. Trademarks.
   d. Accrued losses on firm purchase commitments.

N82#34. When measuring the current cost of inventories in accordance with FASB Statement No. 33, the “entry” date can mean which of the following?

<table>
<thead>
<tr>
<th>Beginning of year</th>
<th>Date of sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N82#36. A method of accounting based on measures of historical prices in dollars, each of which has the same general purchasing power, is
c. Historical cost/constant dollar accounting.
d. Historical cost/nominal dollar accounting.

N82#39. In accordance with FASB Statement No. 33, purchasing power gain or loss results from which of the following?

<table>
<thead>
<tr>
<th>Monetary assets and liabilities</th>
<th>Nonmonetary assets and liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N81#6. FASB Statement No. 33 requires that the current cost for inventories be measured as the
a. Recoverable amount regardless of the current cost.
b. Current cost regardless of the recoverable amount.
c. Higher of current cost or recoverable amount.
d. Lower of current cost or recoverable amount.

N81#7. When computing information on a historical cost/constant dollar basis, which of the following is classified as nonmonetary?
   a. Cash surrender value of life insurance.
   b. Long-term receivables.
   c. Allowance for doubtful accounts.
   d. Inventories, other than inventories used on contracts.

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

A. Cash, Marketable Securities, and Investments

M85#4. The amount by which the aggregate cost of a marketable equity securities portfolio exceeds its market value should be accounted for as a valuation allowance when the portfolio is classified as

<table>
<thead>
<tr>
<th>Current</th>
<th>Noncurrent</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M85#5. An investor uses the equity method to account for investments in common stock. The purchase price implies a fair value of the investee’s depreciable assets in excess of the investee’s net asset carrying values. The investor’s amortization of the excess
a. Decreases the investment account.
b. Decreases the goodwill account.
c. Increases the investment revenue account.
d. Does not affect the investment account.

M84#6. An investor purchased a bond classified as a long-term investment between interest dates at a premium. At the purchase date, the carrying value of the bond is more than the

<table>
<thead>
<tr>
<th>Cash paid to seller</th>
<th>Face value of bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
N83#5. A security in a current marketable equity securities portfolio is transferred to a noncurrent marketable equity securities portfolio. The security should be transferred between the corresponding portfolios at:
   a. The book value at date of transfer if higher than the market value at date of transfer.
   b. The market value at date of transfer, regardless of its cost.
   c. Its cost, regardless of the market value at date of transfer.
   d. The lower of its cost or market value at date of transfer.

N83#6. Cash dividends declared out of current earnings are distributed to an investor. How will the investor's investment account be affected by those dividends under each of the following accounting methods?

<table>
<thead>
<tr>
<th>Cost method</th>
<th>Equity method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

N83#8. Accumulated changes in the valuation allowance for a long-term marketable equity securities portfolio should be a component of:
   a. Current assets.
   b. Noncurrent assets.
   c. Noncurrent liabilities.
   d. Net income.

N83#9. An investor purchased a bond as a long-term investment on January 1. Annual interest was received on December 31. The investor's interest income for the year would be lowest if the bond was purchased at:
   a. A discount.
   b. A premium.
   c. Par.
   d. Face value.

N83#10. When an investor uses the equity method to account for investments in common stock, the investment account will be increased when the investor recognizes:
   a. A proportionate interest in the net income of the investee.
   b. A cash dividend received from the investee.
   c. Periodic amortization of the goodwill related to the purchase.
   d. Depreciation related to the excess of market value over book value of the investee's depreciable assets at the date of purchase by the investor.

N82#5. When an investor uses the cost method to account for investments in common stock, cash dividends received by the investor from the investee should normally be recorded as:
   a. Dividend income.
   b. An addition to the investor's share of the investee's profit.
   c. A deduction from the investor's share of the investee's profit.
   d. A deduction from the investment account.

N81#16. Which of the following conditions generally exists before market value can be used as the basis for valuation of a company's marketable equity securities?
   a. Management's intention must be to dispose of the securities within one year.
   b. Market value must be less than cost for each security held in the company's marketable equity security portfolio.
   c. Market value must approximate historical cost.
   d. The aggregate market value of a company's marketable equity security portfolio must be less than the aggregate cost of the portfolio.

B. Receivables and Accruals

N84#8. On October 1, 1983, a company received a one-year note receivable bearing interest at the market rate. The face amount of the note receivable and the entire amount of the interest are due on September 30, 1984. The interest receivable account at December 31, 1983 would consist of an amount representing:
   a. Three months of accrued interest income.
   b. Nine months of accrued interest income.
   c. Twelve months of accrued interest income.
   d. The excess at October 1, 1983 of the present value of the note receivable over its face value.

N84#9. When the allowance method of recognizing bad debt expense is used, the entries at the time of collection of a small account previously written off would:
   a. Increase net income.
   b. Have no effect on total current assets.
   c. Increase working capital.
   d. Decrease total current liabilities.

M84#7. A 90-day 15% interest-bearing note receivable is sold to a bank after being held for 30 days. The proceeds are calculated using an 18% interest rate. The note receivable has been

<table>
<thead>
<tr>
<th>Discounted</th>
<th>Pledged</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Selected Questions

M84#8. A company is in its first year of operations and has never written off any accounts receivable as uncollectible. When the allowance method of recognizing bad debt expense is used, the entry to recognize that expense
   a. Increases net income.
   b. Decreases current assets.
   c. Has no effect on current assets.
   d. Has no effect on net income.

M86#7. After being held for 30 days, a 90-day 15% interest-bearing note receivable was discounted at a bank at 18%. The proceeds received from the bank upon discounting would be the
   a. Maturity value less the discount at 18%.
   b. Maturity value plus the discount at 18%.
   c. Face value less the discount at 18%.
   d. Face value plus the discount at 18%.

M83#8. On July 1, 1983, a company received a one-year note receivable bearing interest at the market rate. The face amount of the note receivable and the entire amount of the interest are due on June 30, 1984. When the note receivable was recorded on July 1, 1983, which of the following were debited?

<table>
<thead>
<tr>
<th>Interest receivable</th>
<th>Unearned discount on note receivable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

c. Factored.
d. Discounted.

C. Inventories

M85#6. Theoretically, freight costs incurred in the transfer of consigned goods from the consignor to the consignee should be considered
   a. An expense by the consignee.
   b. An expense by the consignor.
   c. Inventoriable by the consignee.
   d. Inventoriable by the consignor.

M85#7. When the double extension approach to the dollar value LIFO inventory cost flow method is used, the inventory layer added in the current year is multiplied by an index number. How would the following be used in the calculation of this index number?

- Ending inventory at current year cost
- Ending inventory at base year cost

<table>
<thead>
<tr>
<th>Numerator</th>
<th>Denominator</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>b.</td>
</tr>
<tr>
<td>c.</td>
<td>d.</td>
</tr>
</tbody>
</table>

M85#8. The original cost of an inventory item is above the replacement cost and above the net realizable value. The replacement cost is below the net realizable value less the normal profit margin. Under the lower of cost or market method the inventory item should be priced at its
   a. Original cost.
   b. Replacement cost.
   c. Net realizable value.
   d. Net realizable value less the normal profit margin.

M84#10. Theoretically, how should the following affect the costs to be included in a manufacturer's inventory?

<table>
<thead>
<tr>
<th>Insurance on raw materials while in transit</th>
<th>Cash discounts taken on purchased raw materials</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M84#11. Which of the following inventory cost flow methods involves computations based on broad inventory pools of similar items?
   a. Regular quantity of goods LIFO.
   b. Dollar-value LIFO.
   c. Weighted average.
   d. Moving average.

M84#12. The original cost of an inventory item is above the replacement cost. The replacement cost is
above the net realizable value. Under the lower of cost or market method, the inventory item should be priced at its

a. Replacement cost.
b. Original cost.
c. Net realizable value.
d. Net realizable value less the normal profit margin.

N83#9. From a theoretical viewpoint, which of the following costs would be considered inventoryable?

<table>
<thead>
<tr>
<th>Freight</th>
<th>Warehousing</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N83#10. The dollar value LIFO inventory cost flow method uses which of the following?

a. Specific goods (single item) pools.
b. Specific cost identification method.
c. Double-extension method.
d. Moving average method.

N83#11. 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 above the replacement cost and below the net realizable value. As a result, under the lower of cost or market method, the inventory item should be valued at the

a. Replacement cost.
b. Original cost.
c. Net realizable value.
d. Net realizable value less the normal profit margin.

N82#6. The LIFO inventory cost flow method may be applied to which of the following inventory systems?

<table>
<thead>
<tr>
<th>Periodic</th>
<th>Perpetual</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N82#7. Under the retail inventory method, freight-in would be included in the calculation of the goods available for sale for which of the following?

<table>
<thead>
<tr>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M82#7. The double-extension method and the link-chain method are two variations of which of the following inventory cost flow methods?

a. Moving average.
b. FIFO.
c. Dollar value LIFO.
d. Conventional (lower of cost or market) retail.

N81#10. The moving average inventory cost flow method is applicable to which of the following inventory systems?

<table>
<thead>
<tr>
<th>Periodic</th>
<th>Perpetual</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N81#11. The retail inventory method would include which of the following in the calculation of the goods available for sale at both cost and retail?

a. Freight-in.
b. Purchase returns.
c. Markups.
d. Markdowns.

D. Property, Plant, and Equipment Owned or Leased

M85#9. A donated plant asset for which the fair value has been determined, and for which incidental costs were incurred in acceptance of the asset, should be recorded at an amount equal to its

a. Incidental costs incurred.
b. Fair value and incidental costs incurred.
c. Book value on books of donor and incidental costs incurred.
d. Book value on books of donor.

M85#10. A machine with a four-year estimated useful life and an estimated fifteen-percent salvage value was acquired on January 1, 1982. On December 31, 1984, the accumulated depreciation using the sum of the years' digits method would be

a. (Original cost less salvage value) multiplied by \(\frac{1}{4}\).
b. Original cost multiplied by \(\frac{1}{4}\).
c. Original cost multiplied by \(\frac{1}{4}\) less total salvage value.
d. (Original cost less salvage value) multiplied by \(\frac{1}{4}\).

M85#11. A company using the group depreciation method for its delivery trucks retired one of its delivery trucks due to damage before the average service life of the group was reached. An insurance recovery was received. The net book value of these group asset accounts would be decreased by the

a. Original cost of the truck.
b. Original cost of the truck less the insurance recovery received.
Selected Questions

c. Original cost of the truck less depreciation on the truck to the date of retirement.
d. Insurance recovery received.

N84#13. A company purchased land to be used as the site for the construction of a plant. Timber was cut from the building site so that construction of the plant could begin. The proceeds from the sale of the timber should be
a. Classified as other income.
b. Netted against the costs to clear the land and expenses as incurred.
c. Deducted from the cost of the plant.
d. Deducted from the cost of the land.

N84#14. Which type of expenditure occurs when a company installs a higher capacity boiler to heat its plant?

a. Rearrangement.
b. Ordinary repair and maintenance.
c. Addition.
d. Betterment.

N84#15. When equipment is retired, accumulated depreciation is debited for the original cost less any residual recovery under which of the following depreciation methods?

<table>
<thead>
<tr>
<th>Composite depreciation</th>
<th>Group depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N84#16. At its inception, the lease term of Lease D is 80% of the estimated remaining economic life of the leased property. However, the lease term falls within the last 40% of the total estimated economic life of the leased property. The lessee should record Lease D as a(n)

a. Asset and a liability.
b. Asset but not a liability.
c. Neither an asset nor a liability.
d. Expense.

N84#17. Office equipment recorded under a capital lease containing a bargain purchase option should be amortized

a. Over the period of the lease using the interest method of amortization.
b. Over the period of the lease using the straight-line method of amortization.
c. In a manner consistent with the lessee’s normal depreciation policy for owned assets.
d. In a manner consistent with the lessee’s normal depreciation policy for owned assets except that the period of amortization should be the lease term.

M84#9. A donated fixed asset for which the fair value has been determined should be recorded as a debit to fixed assets and a credit to
a. Retained earnings.
b. Additional paid-in capital.
c. Deferred income.
d. Other income.

M84#10. A machine with a four-year estimated useful life and an estimated fifteen-percent salvage value was acquired on January 1. Would depreciation expense using the sum-of-the-years-digits method of depreciation be higher or lower than depreciation expense using the double-declining-balance method of depreciation in the first and second years?

<table>
<thead>
<tr>
<th>First year</th>
<th>Second year</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Higher</td>
<td>Higher</td>
</tr>
<tr>
<td>b. Higher</td>
<td>Lower</td>
</tr>
<tr>
<td>c. Lower</td>
<td>Higher</td>
</tr>
<tr>
<td>d. Lower</td>
<td>Lower</td>
</tr>
</tbody>
</table>

M84#11. A machine with an original estimated useful life of ten years was moved to another location in the factory after it had been in service for three years. The efficiency of the machine is increased for its remaining useful life. The reinstallation costs should be capitalized if the remaining useful life of the machine is

<table>
<thead>
<tr>
<th>Five years</th>
<th>Ten years</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#12. A lease contains a bargain purchase option. In determining the lessee’s capitalizable cost at the beginning of the lease term, the payment called for by the bargain purchase option would

a. Not be capitalized.
b. Be subtracted at its present value.
c. Be added at its exercise price.
d. Be added at its present value.

M84#13. The lessee’s net carrying value of an asset arising from the capitalization of a lease would be periodically reduced by the

a. Total minimum lease payment.
b. Portion of minimum lease payment allocable to interest.
c. Portion of minimum lease payment allocable to reduction of principal.
d. Amortization of the asset.

M83#10. Lyle, Inc., purchased certain plant assets under a deferred payment contract on December 31, 1982. The agreement was to pay $20,000 at the time of pur-
chase and $20,000 at the end of each of the next five
years. The plant assets should be valued at
a. The present value of a $20,000 ordinary annu-
ity for five years.
b. $120,000.
c. $120,000 less imputed interest.
d. $120,000 plus imputed interest.

M83#15. At the end of the expected useful life of a
depreciable asset with an estimated 15% salvage value,
the accumulated depreciation would equal the original
cost of the asset under which of the following depre-
ciation methods?

<table>
<thead>
<tr>
<th></th>
<th>Straight-line</th>
<th>Sum-of-the-years-digits</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M83#16. For a capital lease, an amount equal to the
present value at the beginning of the lease term of
minimum lease payments during the lease term, ex-
cluding that portion of the payments representing ex-
cutory costs such as insurance, maintenance, and
property taxes to be paid by the lessor, together with
any profit thereon, should be recorded by the lessee as a (an)

a. Expense.
b. Liability but not an asset.
c. Asset but not a liability.
d. Asset and a liability.

N82#8. When a company replaces an old asphalt roof
on its plant with a new fiberglass insulated roof, which
of the following types of expenditure occurs?

a. Ordinary repair and maintenance.
b. Addition.
c. Rearrangement.
d. Betterment.

N82#10. In a lease that is recorded as a sales-type
lease by the lessor, the difference between the gross
investment in the lease and the sum of the present
values of the components of the gross investment
should be recognized as income

a. In full at the lease's expiration.
b. In full at the lease's inception.
c. Over the period of the lease using the interest
method of amortization.
d. Over the period of the lease using the straight-
line method of amortization.

N82#12. A fixed asset with a five-year estimated use-
ful life is sold during the second year. How would the
use of the straight-line method of depreciation instead
of the double-declining-balance method of depreciation
affect the amount of gain or loss on the sale of the fixed
asset?

<table>
<thead>
<tr>
<th></th>
<th>Gain</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>b.</td>
<td>No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>c.</td>
<td>Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>d.</td>
<td>Increase</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

N81#12. The composite depreciation method

a. Is applied to a group of homogeneous assets.
b. Is an accelerated method of depreciation.
c. Does not recognize gain or loss on the retire-
ment of single assets in the group.
d. Excludes salvage value from the base of the
depreciation calculation.

E. Intangibles and Other Assets

M85#12. On January 1, 1980, an intangible asset with
a fifty-year estimated useful life was acquired. On Jan-
uary 1, 1985, a review was made of the estimated useful
life, and it was determined that the intangible asset had
an estimated useful life of thirty more years. As a result
of the review, the amount to be amortized should be

a. The original cost at January 1, 1980, allocated
equally over a thirty-five-year life.
b. The original cost at January 1, 1980, allocated
equally over a fifty-year life.
c. The unamortized cost on January 1, 1985, al-
located equally over a forty-year life.
d. The unamortized cost on January 1, 1985, al-
located equally over a thirty-year life.

N84#18. Which of the following amounts incurred in
connection with a trademark should be capitalized?

<table>
<thead>
<tr>
<th></th>
<th>Cost of a successful defense</th>
<th>Registration fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

N84#19. The premium on a four-year insurance policy
expiring on December 31, 1985 was paid in total on
January 1, 1982. Assuming that the original payment
was recorded as a prepaid asset, the balance in the
prepaid asset account on December 31, 1983 would be

a. Lower than the balance on December 31,
1982.
b. Lower than the balance on December 31,
1984.
c. The same as the balance on December 31,
1985.
d. The same as the original payment.
M84#14. The premium on a three-year insurance policy expiring on December 31, 1984 was paid in total on January 1, 1982. Assuming that the original payment was recorded as a prepaid asset, how would total assets and stockholders' equity be affected during 1983?
   a. Total assets would decrease and stockholders' equity would increase.
   b. Both total assets and stockholders' equity would decrease.
   c. Both total assets and stockholders' equity would increase.
   d. Neither total assets nor stockholders' equity would change.

M84#15. At the most recent year end, a company's deferred income tax charge related to a noncurrent liability exceeded a deferred income tax credit related to a current asset. Which of the following should be reported in the company's most recent year-end balance sheet?
   a. The deferred income tax charge as a current asset.
   b. The excess of the deferred income tax charge over the deferred income tax credit as a current asset.
   c. The deferred income tax charge as a noncurrent asset.
   d. The excess of the deferred income tax charge over the deferred income tax credit as a noncurrent asset.

N83#12. A purchased patent has a remaining legal life of 15 years. It should be
   a. Expensed in the year of acquisition.
   b. Amortized over 15 years regardless of its useful life.
   c. Amortized over its useful life if less than 15 years.
   d. Amortized over 40 years.

M83#17. Should the following fees associated with the registration of an internally developed patent be capitalized?

<table>
<thead>
<tr>
<th>Legal fees</th>
<th>Registration fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M83#18. Which of the following assets acquired in 1983 are amortizable?

<table>
<thead>
<tr>
<th>Goodwill</th>
<th>Trademarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M83#19. The premium on a three-year insurance policy expiring on December 31, 1982 was paid in total on January 1, 1980. Assuming that the original payment was recorded as a prepaid asset, how would each of the following be affected in 1982?

<table>
<thead>
<tr>
<th>Prepaid assets</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No change</td>
<td>Increase</td>
</tr>
<tr>
<td>b. No change</td>
<td>No change</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>No change</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

M82#3. On January 1, 1975, an intangible asset with a thirty-five-year estimated useful life was acquired. On January 1, 1980, a review was made of the estimated useful life, and it was determined that the intangible asset had an estimated useful life of forty-five more years. As a result of the review
   a. The original cost at January 1, 1975, should be amortized over a fifty-year life.
   b. The original cost at January 1, 1975, should be amortized over the remaining thirty-year life.
   c. The unamortized cost at January 1, 1980, should be amortized over a forty-year life.
   d. The unamortized cost at January 1, 1980, should be amortized over a thirty-five-year life.

N81#15. The premium on a three-year insurance policy which expires in 1984 was paid in advance in 1980. What is the effect of this transaction on the 1980 financial statements for each of the following?

<table>
<thead>
<tr>
<th>Prepaid assets</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

N81#17. Goodwill represents the excess of the cost of an acquired company over the
   a. Sum of the fair values assigned to identifiable assets acquired less liabilities assumed.
   b. Sum of the fair values assigned to tangible assets acquired less liabilities assumed.
   c. Sum of the fair values assigned to intangible assets acquired less liabilities assumed.
   d. Book value of an acquired company.
III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

M85#14. Which of the following is classified as an accrued payroll liability?

<table>
<thead>
<tr>
<th>Federal income tax withheld</th>
<th>Employee's share of FICA taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M85#15. On October 1, 1982, a company borrowed cash and signed a three-year interest-bearing note on which both the principal and interest are payable on October 1, 1985. At December 31, 1984, accrued interest should
a. Be reported on the balance sheet as a current liability.
b. Be reported on the balance sheet as a non-current liability.
c. Be reported on the balance sheet as part of long-term notes payable.
d. Not be reported on the balance sheet as a liability.

M84#20. Which of the following are generally associated with payables classified as accounts payable?

<table>
<thead>
<tr>
<th>Periodic payment of interest</th>
<th>Secured by collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M81#8. On September 1, 1981, a company borrowed cash and signed a one-year interest-bearing note on which both the principal and interest are payable on September 1, 1982. How will the note payable and the related interest be classified in the December 31, 1981, balance sheet?

<table>
<thead>
<tr>
<th>Note payable</th>
<th>Accrued interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Current payable</td>
<td>Noncurrent liability</td>
</tr>
<tr>
<td>b. Noncurrent liability</td>
<td>Current liability</td>
</tr>
<tr>
<td>c. Current liability</td>
<td>Current liability</td>
</tr>
<tr>
<td>d. Noncurrent liability</td>
<td>No entry</td>
</tr>
</tbody>
</table>

C. Deferred Income Tax Liabilities

M84#20. A machine was purchased in January 1983. The straight-line depreciation method used for financial statement purposes resulted in depreciation expense less than the accelerated cost recovery system deduction used for income tax purposes. Assuming that the company is profitable and that there are and have been no other timing differences, which of the following should be reported in the December 31, 1983 balance sheet?

<table>
<thead>
<tr>
<th>Current deferred income tax credit</th>
<th>Noncurrent deferred income tax credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>b.</td>
</tr>
<tr>
<td>c. Current deferred income tax debit</td>
<td>Noncurrent deferred income tax debit</td>
</tr>
<tr>
<td>d.</td>
<td></td>
</tr>
</tbody>
</table>
Selected Questions

M84#21. Royalties are recognized when received in 1983 for income tax purposes and recognized when earned in 1984 for financial statement purposes. This is an example of a
   a. Permanent difference that gives rise to interperiod tax allocation.
   b. Permanent difference that does not give rise to interperiod tax allocation.
   c. Timing difference that gives rise to interperiod tax allocation.
   d. Timing difference that does not give rise to interperiod tax allocation.

M83#20. A machine with a ten-year useful life is being depreciated on a straight-line basis for financial statement purposes, and over five years for income tax purposes under the accelerated cost recovery system. Assuming that the company is profitable and that there are and have been no other timing differences, the related deferred income taxes would be reported in the balance sheet at the end of the first year of the estimated useful life as a
   b. Current asset.
   c. Noncurrent liability.
   d. Noncurrent asset.

D. Capitalized Lease Liability

N84#22. A six-year capital lease entered into on December 31, 1981 specified equal minimum annual lease payments due on December 31 of each year. The portion of the December 31, 1983 minimum payment applicable to which of the following increased over the corresponding December 31, 1982 minimum payment?

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>Reduction of liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M84#18. The present value of the minimum lease payments should be used by the lessee in the determination of a(an)

<table>
<thead>
<tr>
<th>Capital lease liability</th>
<th>Operating lease liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M83#22. For a six-year capital lease, the portion of the minimum lease payment in the third year applicable to the reduction of the obligation should be
   a. Less than in the second year.
   b. More than in the second year.
   c. The same as in the fourth year.
   d. More than in the fourth year.

M82#4. For which of the following transactions would the use of the present value of an annuity due concept be appropriate in calculating the present value of the asset obtained or liability owed at the date of incurrence?
   a. A capital lease is entered into with the initial lease payment due one month subsequent to the signing of the lease agreement.
   b. A capital lease is entered into with the initial lease payment due upon the signing of the lease agreement.
   c. A ten-year 8% bond is issued on January 2 with interest payable semi-annually on July 1 and January 1 yielding 7%.
   d. A ten-year 8% bond is issued on January 2 with interest payable semi-annually on July 1 and January 1 yielding 9%.

E. Bonds Payable

N84#23. The market price of a bond is the
   a. Present value of its maturity amount plus the present value of all future interest payments.
   b. Maturity amount plus the present value of all future interest payments.
   c. Maturity amount plus all future interest payments.
   d. Present value of its maturity amount only.

N84#24. Theoretically, which of the following could be accounted for as a deferred charge, a reduction of the related debt liability, or an expense of the period of borrowing?
   a. Discount on bonds payable.
   b. Premium on bonds payable.
   c. Bond issue costs.
   d. Loss on extinguishment of debt.

N84#25. How would the amortization of discount on bonds payable affect each of the following?

<table>
<thead>
<tr>
<th>Carrying value</th>
<th>Net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>of bond</td>
<td></td>
</tr>
<tr>
<td>a. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

N84#26. Outstanding bonds are converted into common stock. Under either the book value or market value method, the same amount would be debited to

<table>
<thead>
<tr>
<th>Bonds payable</th>
<th>Premium on bonds payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
M83#14. The market rate of interest for a bond issue which sells for more than its par value is
a. Independent of rate stated on the bond.
b. Higher than rate stated on the bond.
c. Equal to rate stated on the bond.
d. Less than rate stated on the bond.

M83#15. How would the amortization of premium on bonds payable affect each of the following?

<table>
<thead>
<tr>
<th>Carrying value of bond</th>
<th>Net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

M83#16. A gain on the conversion of outstanding bonds into common stock would be recognized when using the

<table>
<thead>
<tr>
<th>Book value method</th>
<th>Market value method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M83#17. Which of the following material gains on refunding of bonds payable should be recognized separately as an extraordinary gain?

<table>
<thead>
<tr>
<th>Direct exchange of old bonds for new bonds</th>
<th>Issuance of new bonds; proceeds used to retire old bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M83#24. For the issuer of a ten-year term bond, the amount of amortization using the interest method would increase each year if the bond was sold at a

<table>
<thead>
<tr>
<th>Discount</th>
<th>Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M83#30. When the issuer of bonds exercises the call provision to retire the bonds, the excess of the cash paid over the carrying amount of the bonds should be recognized separately as a (an)

| a. Extraordinary loss.
b. Extraordinary gain.
c. Loss from continuing operations.
d. Loss from discontinued operations.

M82#6. When the interest payment dates of a bond are May 1 and November 1, and a bond issue is sold on June 1, the amount of cash received by the issuer will be

| a. Increased by accrued interest from June 1 to November 1.
b. Increased by accrued interest from May 1 to June 1.
c. Decreased by accrued interest from June 1 to November 1.
d. Decreased by accrued interest from May 1 to June 1.

M82#8. When the cash proceeds from a bond issued with detachable stock purchase warrants exceeds the sum of the par value of the bonds and the fair value of the warrants, the excess should be credited to

| a. Additional paid-in capital.
b. Retained earnings.
c. Premium on bonds payable.
d. Detachable stock warrants outstanding.

M81#15. How should the cash proceeds from convertible bonds sold at issue date at par be recorded?

| a. As additional paid-in capital for the portion of the proceeds attributable to the conversion feature and as a liability for the portion of the proceeds attributable to the debt.
b. As retained earnings for the portion of the proceeds attributable to the conversion feature and as a liability for the portion of the proceeds attributable to the debt.
c. As a liability for the entire proceeds.
d. As additional paid-in capital for the portion of the proceeds attributable to the conversion feature and as retained earnings for the portion of the proceeds attributable to the debt.

F. Contingent Liabilities and Commitments

M85#16. An expropriation of assets which is imminent and for which the amount of loss can be reasonably estimated should be

<table>
<thead>
<tr>
<th>Accrued</th>
<th>Disclosed</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
Selected Questions

**M84#19.** Which of the following contingencies should generally be recognized on the balance sheet when the occurrence of the contingent event is probable and its amount can be reasonably estimated?

<table>
<thead>
<tr>
<th>Gain contingency</th>
<th>Loss contingency</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**N83#18.** On December 20, 1982, an uninsured property damage loss was caused by a company car being driven on company business by a company salesman. The company did not become aware of the loss until January 25, 1983. The amount of the loss was reasonably estimable before the company’s 1982 financial statements were issued. The company’s December 31, 1982, financial statements should report an estimated loss as

a. A disclosure, but not an accrual.

b. An accrual.

c. Neither an accrual nor a disclosure.

d. An appropriation of retained earnings.

**N82#11.** An estimated loss from a loss contingency that is probable and for which the amount of the loss can be reasonably estimated should

a. Not be accrued but should be disclosed in the notes to the financial statements.

b. Be accrued by debiting an appropriated retained earnings account and crediting a liability account or an asset account.

c. Be accrued by debiting an expense account and crediting an appropriated retained earnings account.

d. Be accrued by debiting an expense account and crediting a liability account or an asset account.

**M82#5.** A particular warranty obligation is probable and the amount of the loss can be reasonably estimated. The particular parties that will make claims under the warranty are not identifiable. An estimated loss contingency should then be

a. Classified as an appropriation of retained earnings.

b. Neither accrued nor disclosed.

c. Disclosed but not accrued.

d. Accrued.

**N81#14.** A threat of expropriation of assets which is reasonably possible, and for which the amount of loss can be reasonably estimated, is an example of a (an)

a. Loss contingency that should be disclosed, but not accrued.

b. Loss contingency that should be accrued and disclosed.

c. Appropriation of retained earnings against which losses should be charged.

d. General business risk which should not be accrued, and need not be disclosed.

**N81#37.** An estimated loss from a loss contingency should be accrued when

a. It is probable at the date of the financial statements that a loss has been incurred and the amount of the loss can be reasonably estimated.

b. The loss has been incurred by the date of the financial statements and the amount of the loss may be material.

c. It is probable at the date of the financial statements that a loss has been incurred and the amount of the loss may be material.

d. It is probable that a loss will be incurred in a future period and the amount of the loss can be reasonably estimated.

**M81#10.** How should a loss contingency that is reasonably possible and for which the amount can be reasonably estimated be reported?

<table>
<thead>
<tr>
<th>Accrued</th>
<th>Disclosed</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
A. Preferred and Common Stock

M85#19. The purchase of treasury stock
a. Decreases common stock authorized.
b. Decreases common stock issued.
c. Decreases common stock outstanding.
d. Has no effect on common stock outstanding.

N81#19. For a company that has only common stock outstanding, total shareholders' equity divided by the number of shares outstanding represents the
a. Return on equity.
b. Stated value per share.
c. Book value per share.
d. Price-earnings ratio.

M81#1. What is the most likely effect of a stock split on the par value per share and the number of shares outstanding?

<table>
<thead>
<tr>
<th>Par value per share</th>
<th>Number of shares outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>c. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

B. Additional Paid-in Capital

N84#27. 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. Additional paid-in capital when the subscription is received.
b. Additional paid-in capital when the subscription is collected.
c. Additional paid-in capital when the common stock is issued.
d. Part of common stock, no par.

N83#19. The excess of the subscription price over the par value should be recorded as additional paid-in capital for

<table>
<thead>
<tr>
<th>Common stock</th>
<th>Preferred stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N82#9. The excess of the subscription price over the par value of nonredeemable preferred stock subscribed should be recorded as
a. A liability.
b. Additional paid-in capital.

c. Retained earnings.
d. Revenue.

N81#20. Authorized common stock is sold on a subscription basis at a price in excess of par value. Additional paid-in capital should be recorded when the subscribed stock is
a. Contracted for.
b. Paid for.
c. Issued.
d. Authorized.

M81#12. How should the excess of the subscription price over the par value of common stock subscribed be recorded?

a. As additional paid-in capital when the subscription is received.
b. As additional paid-in capital when the subscription is collected.
c. As retained earnings when the subscription is received.
d. As additional paid-in capital when the capital stock is issued.

C. Retained Earnings and Dividends

M85#17. How would a stock split affect each of the following?

<table>
<thead>
<tr>
<th>Assets</th>
<th>Total stockholders' equity</th>
<th>Additional paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. No effect</td>
<td>No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>c. No effect</td>
<td>No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

N84#28. How would the declaration and subsequent issuance of a 10% stock dividend by the issuer affect each of the following when the market value of the shares exceeds the par value of the stock?

<table>
<thead>
<tr>
<th>Common stock</th>
<th>Additional paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>b. No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>d. Increase</td>
<td>Increase</td>
</tr>
</tbody>
</table>

M84#22. Which of the following should be reflected, net of applicable income taxes, in the statement of stockholders' equity as an adjustment of the opening balance in retained earnings?

a. Correction of an error in previously issued financial statements.
b. Cumulative effect of a change in depreciation method.
Selected Questions

c. Loss on disposal of a segment of a business.
d. Extraordinary item.

M84#23. How would the declaration of a 10% stock dividend by a corporation affect each of the following on its books?

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>Total stockholders' equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M83#20. A property dividend should be debited to retained earnings at the property's
a. Market value at date of declaration.
b. Market value at date of issuance (payment).
c. Book value at date of declaration.
d. Book value at date of issuance (payment).

M83#21. The issuer should charge retained earnings for the market value of the shares issued in a (an)
a. 10 percent stock dividend.
b. 2 for 1 stock split.
c. Employee stock bonus.
d. Pooling of interests.

M82#13. The correction of an error in the financial statements of a prior period should be reflected, net of applicable income taxes, in the current
a. Income statement after income from continuing operations and before extraordinary items.
b. Income statement after income from continuing operations and after extraordinary items.
c. Retained earnings statement as an adjustment of the opening balance.
d. Retained earnings statement after net income but before dividends.

M82#10. The dollar amount of total stockholders' equity remains the same when there is a (an)
a. Issuance of preferred stock in exchange for convertible debentures.
b. Issuance of nonconvertible bonds with detachable stock purchase warrants.
c. Declaration of a stock dividend.
d. Declaration of a cash dividend.

M81#24. A prior period adjustment should be reflected, net of applicable income taxes, in the financial statements of a business entity in the
a. Retained earnings statement after net income but before dividends.
b. Retained earnings statement as an adjustment of the opening balance.
c. Income statement after income from continuing operations.
d. Income statement as part of income from continuing operations.

M81#13. An example of an item which should be reported as a prior period adjustment is the
a. Collection of previously written-off accounts receivable.
b. Payment of taxes resulting from examination of prior year income tax returns.
c. Correction of error in financial statements of a prior year.
d. Receipt of insurance proceeds for damage to building sustained in a prior year.

D. Treasury Stock and Other Contra Accounts

M85#18. Ten thousand shares of $20 par value common stock were initially issued at $25 per share. Subsequently, two thousand of these shares were purchased as treasury stock at $30 per share. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect of the purchase of the treasury stock on the amount reported in the balance sheet for each of the following?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

M84#29. 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 sale of treasury stock using the par-value method.
c. It reverses the original entry to issue the common stock with any difference being shown as an ordinary gain or loss and does not recognize any gain or loss on a subsequent resale of the stock.
d. 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 resale like a new issuance of common stock.

M84#25. Treasury stock was acquired for cash at more than its par value, and then subsequently sold for cash at more than its acquisition price. Assuming that the
cost method of accounting for treasury stock transactions is used, what is the effect on additional paid-in capital from treasury stock transactions?

<table>
<thead>
<tr>
<th>Purchase of treasury stock</th>
<th>Sale of treasury stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>b. No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>No effect</td>
</tr>
</tbody>
</table>

**N83#22.** When treasury stock is purchased for cash at more than its par value, what is the effect on total stockholders' equity under each of the following methods?

<table>
<thead>
<tr>
<th>Cost method</th>
<th>Par value method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

**M83#27.** When treasury stock accounted for by the cost method is subsequently sold for more than its purchase price, the excess of the cash proceeds over the carrying value of the treasury stock should be recognized as

a. Extraordinary gain.

b. Income from continuing operations.

c. Increase in additional paid-in capital.

d. Increase in retained earnings.

**N82#19.** Ten thousand (10,000) shares of common stock with a par value of $20 per share were initially issued at $25 per share. Subsequently, two thousand (2,000) of these shares were purchased as treasury stock at $30 per share. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect of the purchase of the treasury stock on each of the following?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Increase</td>
<td>No effect</td>
</tr>
</tbody>
</table>

**M82#11.** When treasury stock is purchased for more than its par value, treasury stock is debited for the purchase price under which of the following methods?

<table>
<thead>
<tr>
<th>Cost method</th>
<th>Par value method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**N81#22.** When treasury stock which was purchased for more than the par value of the stock is subsequently sold for more than its purchase price, additional paid-in capital from the sale of the treasury stock is credited under which of the following methods?

<table>
<thead>
<tr>
<th>Cost method</th>
<th>Par value method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**E. Stock Options, Warrants, and Rights**

**M85#13.** A company issued rights to its existing shareholders to purchase, for $30 per share, unissued shares of $15 par value common stock. When the rights lapse

a. No entry will be made.

b. Additional paid-in capital will be debited.

c. Additional paid-in capital will be credited.

d. Stock rights outstanding will be debited.

**M84#13.** A company issued rights to its existing shareholders to purchase for par unissued shares of common stock with a par value of $10 per share. When the market value of the common stock was $12 per share, the rights were exercised. Common stock should be credited at $10 per share and

a. Appropriation for stock retirement credited at $2 per share.

b. No credit made to additional paid-in capital or retained earnings.

c. Additional paid-in capital credited at $2 per share.

d. Retained earnings credited at $2 per share.

**M84#24.** A company issued rights to its existing shareholders to purchase for $15 per share, 5,000 unissued shares of common stock with a par value of $10 per share. Common stock will be credited at

a. $15 per share when the rights are exercised.

b. $15 per share when the rights are issued.

c. $10 per share when the rights are exercised.

d. $10 per share when the rights are issued.

**N83#23.** A company issued rights to its existing shareholders to purchase, for $30 per share, 10,000 unissued shares of $15 par value common stock. When the rights are exercised

a. Additional paid-in capital will be debited.

b. Additional paid-in capital will be credited.

c. Stock rights outstanding will be debited.

d. Retained earnings will be debited.

**M82#13.** Which of the following is issued to shareholders by a corporation as evidence of the ownership of rights to acquire its unissued or treasury stock?

a. Stock options.

b. Stock warrants.

c. Stock dividends.

d. Stock subscriptions.
Selected Questions

N81#23. The granting by a company to its shareholders of the opportunity to buy additional shares of stock within a specified future time at a specified price is an example of a
   a. Dividend reinvestment plan.
   b. Stock right.
   c. Stock dividend.
   d. Stock option.

M85#9. How should the value of warrants attached to a debt security be accounted for?
   a. No value assigned.
   b. A separate portion of paid-in capital.
   c. An appropriation of retained earnings.
   d. A liability.

G. Partnerships

M85#20. When Dee retired from the partnership of Dee, Ken, and Ned, the final settlement of Dee’s part-

nership interest exceeded Dee’s capital balance. Under the bonus method, the excess
   a. Reduced the capital balances of Ken and Ned.
   b. Had no effect on the capital balances of Ken and Ned.
   c. Was recorded as goodwill.
   d. Was recorded as an expense.

M84#26. The partnership agreement for the partnership of Mayo and Pack provided for salary allowances of $45,000 to Mayo and $35,000 to Pack, and the residual profit was allocated equally. During 1983, Mayo and Pack each withdrew cash equal to 80 percent of their salary allowances. If during 1983 the partnership had profits in excess of $100,000 without regard to salary allowances and withdrawals, Mayo’s equity in the partnership would
   a. Increase more than Pack’s.
   b. Decrease more than Pack’s.
   c. Increase the same as Pack’s.
   d. Decrease the same as Pack’s.

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

M85#21. A company used 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 second year?

<table>
<thead>
<tr>
<th>Income previously recognized</th>
<th>Progress billings to date</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M85#22. 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

<table>
<thead>
<tr>
<th>Wages expense</th>
<th>Sales to customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M85#32. The calculation of the income recognized in the second year of a four-year construction contract which is accounted for using the percentage-of-completion method is based on the
   a. Cumulative actual costs incurred only.
   b. Incremental cost for the second year only.
   c. Latest available estimated costs.
   d. Estimated costs at the inception of the contract.

N84#32. The calculation of the income recognized in the first year of a four-year construction contract accounted for using the percentage-of-completion method is generally based on the ratio of
   a. Total estimated costs to estimated costs to complete.
   b. Total estimated costs to actual costs incurred to date.
   c. Actual costs incurred to date to total estimated costs.
   d. Estimated costs to complete to total estimated costs.

N84#33. An investor uses the equity method to account for its 30% investment in common stock of an investee. Amortization of the investor’s share of the excess of fair market value over book value of depreciable assets at the date of the purchase should be reported in the investor’s income statement as part of
   a. Other expense.
   b. Depreciation expense.
   c. Equity in earnings of investee.
   d. Amortization of goodwill.
M84#34. At the time progress billings are sent on a long-term contract, income is recognized under the

<table>
<thead>
<tr>
<th>Completed-contract method</th>
<th>Percentage-of-completion method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N83#24. When an investor uses the equity method to account for investments in common stock, the equity in the earnings of the investee reported in the investor’s income statement will be affected by which of the following?

<table>
<thead>
<tr>
<th>Cash dividends from investee</th>
<th>Goodwill amortization related to purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N83#25. A sale of goods, denominated in a currency other than the entity’s functional currency, 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. The resulting gain should be included as a (an)

a. Separate component of stockholders’ equity.
b. Deferred credit.
c. Component of income from continuing operations.
d. Extraordinary item.

M83#26. When should an indicated loss on a long-term contract be recognized under the completed-contract method and the percentage-of-completion method, respectively?

<table>
<thead>
<tr>
<th>Completed-contract</th>
<th>Percentage-of-completion</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Immediately</td>
<td>Over life of project</td>
</tr>
<tr>
<td>b. Immediately</td>
<td>Immediately</td>
</tr>
<tr>
<td>c. Contract complete</td>
<td>Over life of project</td>
</tr>
<tr>
<td>d. Contract complete</td>
<td>Immediately</td>
</tr>
</tbody>
</table>

M83#28. In a lease that is recorded as a sales-type lease by the lessor, unearned interest

a. Does not arise.
b. Should be recognized in full as income at the lease’s inception.
c. Should be amortized over the period of the lease using the straight-line method.
d. Should be amortized over the period of the lease using the interest method.

M83#29. Rent received in advance by the lessor for an operating lease should be recognized as revenue

a. When received.
b. At the lease’s inception.
c. In the period specified by the lease.
d. At the lease’s expiration.

N82#17. The excess of the fair value of leased property at the inception of the lease over its cost or carrying amount should be classified by the lessor as

a. Unearned income from a sales-type lease.
b. Unearned income from a direct-financing lease.
c. Manufacturer’s or dealer’s profit from a sales-type lease.
d. Manufacturer’s or dealer’s profit from a direct-financing lease.

N81#29. For a troubled debt restructuring involving only modification of terms, it is appropriate for a debtor to recognize a gain when the carrying amount of the debt

a. Exceeds the total future cash payments specified by the new terms.
b. Is less than the total future cash payments specified by the new terms.
c. Exceeds the present value specified by the new terms.
d. Is less than the present value specified by the new terms.

N81#34. Which of the following would be used in the calculation of the income recognized in the third and final year of a construction contract which is accounted for using the percentage-of-completion method?

<table>
<thead>
<tr>
<th>Contract price</th>
<th>Actual total costs</th>
<th>Income previously recognized</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M81#14. When a fixed asset with a five-year estimated useful life is sold during the second year, how would the use of the sum-of-the-years-digits method of depreciation instead of the straight-line method of depreciation affect the gain or loss on the sale of the fixed asset?

<table>
<thead>
<tr>
<th>Gain</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

B. Expenses and Losses

M85#23. Compensatory stock options were granted to executives on January 1, 1983, with a measurement date of June 30, 1984, for services to be rendered during 1983, 1984, and 1985. 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 April 30, 1985. Compensation expense should be recognized in the income statement in which of the following years?

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1984</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

N84#34. A subsidiary’s functional currency is the local currency which has not experienced significant inflation. The appropriate exchange rate for translating the depreciation on plant assets in the income statement of the foreign subsidiary is the
a. Exit exchange rate.
b. Historical exchange rate.
c. Weighted average exchange rate over the economic life of each plant asset.
d. Weighted average exchange rate for the current year.

N84#35. For a compensatory stock option plan for which the date of grant and the measurement date are different, compensation cost should be recognized in the income statement
a. At the later of grant or measurement date.
b. At the exercise date.
c. At the adoption date of the plan.
d. Of each period in which the services are rendered.

N84#26. In determining whether to accrue employees’ compensation for future absences, one of the conditions that must be met is that the employer has an obligation to make payment even if an employee terminates. This is an example of a (an)
a. Vested right.
b. Accumulated right.
c. Contingent right.
d. Estimable right.

N84#27. In the calculation of the annual provision for pension cost, 10 percent of past service cost (until fully amortized) would be included in the

<table>
<thead>
<tr>
<th>Minimum limit</th>
<th>Maximum limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M83#31. The sum-of-the-years-digits method of depreciation is being used for a machine with a five-year estimated useful life. What would be the fraction applied to the cost to be depreciated in the second year?

a. 2/3.
b. 2/15.
c. 4/15.
d. 4/5.

M83#32. Compensation cost should be recognized in the income statement of each period in which services are rendered for a compensatory stock option plan for which the date of grant and the measurement date are

<table>
<thead>
<tr>
<th>Different</th>
<th>Identical</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M83#33. The maximum annual provision for pension cost permitted is normal cost, plus
a. 10 percent of past service cost (until fully amortized).
b. 10 percent of past service cost (until fully amortized), plus 10 percent of any increases or decreases in prior service cost arising on amendments of the plan, plus interest equivalents on the difference between provisions and amounts funded.
c. Interest equivalents on any unfunded prior service cost, plus a provision for the excess of the actuarially computed value of vested benefits over the total of the pension fund if such excess is not at least 5 percent less than the comparable excess at the beginning of the year.
d. A provision for vested benefits.

M84#28. A material loss should be presented separately as a component of income from continuing operations when it is
a. An extraordinary item.
b. A cumulative effect type change in accounting principle.
c. Infrequent in occurrence but not unusual in nature.
d. Infrequent in occurrence and unusual in nature.

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M82#21. In a period of rising prices, the use of which of the following inventory cost flow methods would result in the highest cost of goods sold?
   a. FIFO.
   b. LIFO.
   c. Weighted average cost.
   d. Moving average cost.

M82#22. In a periodic inventory system which uses the FIFO cost flow method, the cost of goods available for sale is net purchases
   a. Plus the ending inventory.
   b. Plus the beginning inventory.
   c. Minus the ending inventory.
   d. Minus the beginning inventory.

M82#23. In the calculation of the maximum limit for the annual provision for pension cost, the past service cost portion of the calculation should not be greater than
   a. Ten percent of the past service cost (until fully amortized).
   b. Ten percent of the actuarially computed value of the vested benefits.
   c. Seventy-five percent of the normal cost.
   d. An amount equivalent to amortization of the past service cost on a forty-year basis.

M82#31. When the allowance method of recognizing bad debt expense is used, the typical write-off of a specific customer's account
   a. Has no effect on net income.
   b. Decreases net income.
   c. Decreases current assets.
   d. Decreases working capital.

M82#34. Which of the following utilizes the straight-line depreciation method?
   a. No
   b. No
   c. Yes
   d. Yes

N81#21. In a periodic inventory system which uses the LIFO inventory cost flow method, the cost of goods sold is the total cost of goods available for sale
   a. Plus the ending inventory.
   b. Minus the ending inventory.
   c. Plus the beginning inventory.
   d. Minus the beginning inventory.

N81#25. Actuarial gains or losses directly related to the operation of a pension plan should be
   a. Allocated to current and future periods.
   b. Deferred until pension plan investments give rise to actuarial gains or losses.

T-22
Selected Questions

c. Offset against pension expense in year of occurrence.
d. Disclosed in a note to the financial statements only.

M81#26. In a lease that is recorded as an operating lease by the lessee, the equal monthly rental payments should be
   a. Allocated between interest expense and depreciation expense.
   b. Allocated between a reduction in the liability for leased assets and interest expense.
   c. Recorded as a reduction in the liability for leased assets.
d. Recorded as rental expense.

M81#17. Which of the following depreciation methods is computed in the same way as depletion is computed?
   a. Straight-line.
   b. Sum-of-the-years-digits.
d. Productive-output.

M81#19. For a compensatory stock option plan for which the date of grant and the measurement date are the same, compensation cost should be recognized in the income statement
   a. At the date of retirement.
   b. Of each period in which services are rendered.
   c. At the exercise date.
d. At the adoption date of the plan.

M81#20. In which of the following methods is salvage value not considered in the calculation of the first year's depreciation on fixed assets?
   a. Straight-line.
   b. Double-declining-balance.
   c. Sum-of-the-years-digits.
d. Productive-output.

M81#21. A transaction that is material in amount, unusual in nature, but not infrequent in occurrence, should be presented separately as a (an)
   a. Component of income from continuing operations, but not net of applicable income taxes.
   b. Component of income from continuing operations, net of applicable income taxes.
   c. Extraordinary item, net of applicable income taxes.
d. Prior period adjustment, but not net of applicable income taxes.

C. Provision for Income Tax

M84#36. Which of the following interperiod tax allocation methods should be followed?

<table>
<thead>
<tr>
<th>Deferred</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>
d. No

M83#35. Assuming no prior period adjustments, would the following affect net income?

<table>
<thead>
<tr>
<th>Interperiod income tax allocation</th>
<th>Intraperiod income tax allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>
d. No

M82#14. Which of the following could require interperiod tax allocation?
   a. Premiums paid on officers' life insurance.
   b. Unearned service contract revenue.
   c. Interest received on municipal obligations.
d. Dividends received exclusion.

M81#28. Intraperiod income tax allocation arises because
   a. Items included in the determination of taxable income may be presented in different sections of the financial statements.
   b. Income taxes must be allocated between current and future periods.
   c. Certain revenues and expenses appear in the financial statements either before or after they are included in taxable income.
   d. Certain revenues and expenses appear in the financial statements but are excluded from taxable income.

M81#35. Interperiod income tax allocation is justified by the basic theory that income taxes should be treated as which of the following?
   a. An expense for the current portion and a distribution of earnings for the deferred portion.
   b. An expense.
   c. A distribution of earnings for the current portion and an expense for the deferred portion.
d. A distribution of earnings.

D. Recurring Versus Nonrecurring Transactions and Events

M85#24. When a segment of a business has been discontinued during the year, this segment's operating
losses of the current period up to the measurement date should be included in the
a. Income statement as part of the income (loss) from operations of the discontinued segment.
b. Income statement as part of the loss on disposal of the discontinued segment.
c. Income statement as part of the income (loss) from continuing operations.
d. Retained earnings statement as a direct decrease in retained earnings.

N83#28. When a segment of a business has been discontinued during the year, the loss on disposal should
a. Be an extraordinary item.
b. Be an operating item.
c. Exclude operating losses of the current period up to the measurement date.
d. Exclude operating losses during the phase-out period.

N83#29. A loss from early extinguishment of debt, if material, should be reported as a component of income
a. After cumulative effect of accounting changes and after discontinued operations of a segment of a business.
b. After cumulative effect of accounting changes and before discontinued operations of a segment of a business.
c. Before cumulative effect of accounting changes and after discontinued operations of a segment of a business.
d. Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.

M82#29. Which of the following items, if material, should be presented in the income statement separately as a component of income, net of applicable income taxes?
a. Write-off of goodwill.
b. Losses due to a strike.
c. Losses from translation of foreign currencies.
d. Gain from early extinguishment of long-term debt.

N81#30. A loss from the disposal of a segment of a business enterprise should be reported separately as a component of income
a. After cumulative effect of accounting changes and before extraordinary items.
b. Before cumulative effect of accounting changes and after extraordinary items.
c. After extraordinary items and cumulative effect of accounting changes.
d. Before extraordinary items and cumulative effect of accounting changes.

M81#22. An extraordinary item should be reported separately as a component of income

b. Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.
c. After cumulative effect of accounting changes and after 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

M83#36. When a cumulative effect type change in accounting principle is made during the year, the cumulative effect on retained earnings is determined
a. During the year using the weighted-average method.
b. As of the date of the change.
c. As of the beginning of the year in which the change is made.
d. As of the end of the year in which the change is made.

M82#25. A company changes from the double-declining-balance method of depreciation for previously recorded assets to the straight-line method. The cumulative effect of the change on the amount of retained earnings at the beginning of the period in which the change is made should be reported separately as a (an)
a. Extraordinary item.
b. Component of income after extraordinary items.
c. Component of income from continuing operations.
d. Prior period adjustment.

M81#23. An example of a special change in accounting principle that should be reported by restating the financial statements of prior periods is the change from the
a. Straight-line method of depreciating plant equipment to the sum-of-the-years-digits method.
b. Sum-of-the-years-digits method of depreciating plant equipment to the straight-line method.
c. LIFO method of inventory pricing to the FIFO method.
d. FIFO method of inventory pricing to the LIFO method.

F. Earnings Per Share

M85#25. Antidilutive common stock equivalents would generally be used in the calculation of
Selected Questions

<table>
<thead>
<tr>
<th>Primary earnings per share</th>
<th>Fully diluted earnings per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N84#27. In determining earnings per share, interest expense, net of applicable income taxes, on convertible debt which is both a common stock equivalent and dilutive should be

a. Added back to net income for both primary earnings per share and fully diluted earnings per share.

b. Added back to net income for primary earnings per share, and ignored for fully diluted earnings per share.

c. Deducted from net income for both primary earnings per share and fully diluted earnings per share.

d. Deducted from net income for primary earnings per share, and ignored for fully diluted earnings per share.

N84#29. In determining primary earnings per share, dividends on nonconvertible cumulative preferred stock should be

a. Disregarded.

b. Added back to net income whether declared or not.

c. Deducted from net income only if declared.

d. Deducted from net income whether declared or not.

N81#31. When computing primary earnings per share, common stock equivalents are

a. Recognized only if they are dilutive.

b. Recognized only if they are antidilutive.

c. Recognized whether they are dilutive or antidilutive.

d. Ignored.

N81#32. A company with a simple capital structure for purposes of computing earnings per share would include which of the following in the computation of earnings per share?

a. Dividends on nonconvertible cumulative preferred stock.

b. Dividends on common stock.

c. Common stock equivalents.

d. Number of shares of nonconvertible cumulative preferred stock.

M81#24. When computing fully diluted earnings per share, convertible securities that are not common stock equivalents are

a. Ignored.

b. Recognized whether they are dilutive or antidilutive.

c. Recognized only if they are dilutive.

d. Recognized only if they are anti-dilutive.

M81#25. For purposes of computing the weighted-average of shares outstanding during the year, a midyear event that must be treated as occurring at the beginning of the year is

a. Declaration and payment of stock dividend.

b. Purchase of treasury stock.

c. Sale of additional common stock.

d. Issuance of stock warrants.

VI. Other Financial Topics

A. Statement of Changes in Financial Position

M85#26. A gain on the sale of a plant asset in the ordinary course of business should be presented in a statement of changes in financial position as a(an)

a. Source and a use of funds.

b. Use of funds.

c. Addition to income from continuing operations.

d. Deduction from income from continuing operations.

M85#27. Which of the following should be presented in a statement of changes in financial position?

<table>
<thead>
<tr>
<th>Conversion of long-term debt to common stock</th>
<th>Conversion of preferred stock to common stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N84#38. Bad debt expense on long-term receivables should be presented in a statement of changes in financial position as a (an)

a. Addition to income from continuing operations.

b. Deduction from income from continuing operations.

c. Use of funds.

d. Source and a use of funds.
N84#39. The declaration of a 10% stock dividend has to be presented in a statement of changes in financial position as

<table>
<thead>
<tr>
<th>Source of funds</th>
<th>Use of funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#30. A loss on the sale of machinery in the ordinary course of business should be presented in a statement of changes in financial position as (an)

a. Deduction from income from continuing operations.
b. Addition to income from continuing operations.
c. Source and a use of funds.
d. Use of funds.

M84#31. The purchase for cash of treasury stock should be presented in a statement of changes in financial position as a

<table>
<thead>
<tr>
<th>Source of funds</th>
<th>Use of funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N83#30. The conversion of nonparticipating preferred stock into common stock should be presented in a statement of changes in financial position as a

<table>
<thead>
<tr>
<th>Source of funds</th>
<th>Use of funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N83#31. In a statement of changes in financial position, the amortization of goodwill of a company with substantial operating profits should be presented as a (an)

a. Source and use of funds.
b. Use of funds.
c. Deduction from income from continuing operations.
d. Addition to income from continuing operations.

M83#36. A gain on the sale of a long-term investment should be presented in a statement of changes in financial position of a company with substantial operating profits as a (an)

a. Deduction from income from continuing operations.
b. Addition to income from continuing operations.
c. Source and use of funds.
d. Use of funds.

N82#27. Which of the following should be presented in a statement of changes in financial position only because of the all-financial-resources concept?

a. Conversion of preferred stock to common stock.
b. Purchase of treasury stock.
c. Sale of common stock.
d. Declaration of cash dividend.

M82#27. The amortization of bond discount on long-term debt should be presented in a statement of changes in financial position as (an)

a. Use of funds.
b. Source and a use of funds.
c. Addition to income.
d. Deduction from income.

N81#33. The amortization of patents should be presented in a statement of changes in financial position as (an)

a. Source and use of funds.
b. Use of funds.
c. Addition to net income.
d. Deduction from net income.

M81#26. When preparing a statement of changes in financial position (defining funds as cash), an increase in ending inventory over beginning inventory will result in an adjustment to reported net earnings because

a. Funds were increased since inventory is a current asset.
b. Inventory is an expense deducted in computing net earnings, but is not a use of funds.
c. The net increase in inventory reduces cost of goods sold and represents an assumed use of cash.
d. All changes in non-cash accounts must be disclosed under the all-financial-resources concept.

M81#27. In a statement of changes in financial position (defining funds as working capital), bad debt expense should be added back to net income when it relates to

<table>
<thead>
<tr>
<th>Current receivables</th>
<th>Long-term receivables</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>
B. Accounting Policies

N82#36. Which of the following should be disclosed in the Summary of Significant Accounting Policies?
   a. Composition of plant assets.
   b. Pro forma effect of retroactive application of an accounting change.
   c. Basis of consolidation.
   d. Maturity dates of long-term debt.

N82#37. Which of the following facts concerning plant assets should be disclosed in the Summary of Significant Accounting Policies?

<table>
<thead>
<tr>
<th>Composition</th>
<th>Depreciation expense amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N81#28. Which of the following should be disclosed in the Summary of Significant Accounting Policies?
   a. Rent expense amount.
   b. Maturity dates of long-term debt.
   c. Methods of amortizing intangibles.
   d. Composition of plant assets.

C. Accounting Changes

N85#28. When a company changes from the straight-line method of depreciation for previously recorded assets to the double-declining-balance method, which of the following should be reported?

<table>
<thead>
<tr>
<th>Cumulative effect of change in accounting principle</th>
<th>Pro forma effects of retroactive application</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N84#40. A change in the expected service life of an asset arising because additional information has been obtained is
   a. An accounting change that should be reported by restating the financial statements of all prior periods presented.
   b. An accounting change that should be reported in the period of change and future periods if the change affects both.
   c. A correction of an error.
   d. Not an accounting change.

N84#32. The cumulative effect of an accounting change, on the amount of retained earnings at the beginning of the period in which the change is made, should generally be included in net income for the period of the change for a

N83#32. A company has included in its consolidated financial statements this year a subsidiary acquired several years ago that was appropriately excluded from consolidation last year. This results in
   a. An accounting change that should be reported prospectively.
   b. An accounting change that should be reported by restating the financial statements of all prior periods presented.
   c. A correction of an error.
   d. Neither an accounting change nor a correction of an error.

N83#40. Pro forma effects of retroactive application would usually be reported on the face of the income statement for a
   a. Correction of error.
   b. Change in entity.
   c. Change in accounting estimate.
   d. Change in accounting principle.

N82#28. A change in the salvage value of an asset depreciated on a straight-line basis and arising because additional information has been obtained is
   a. An accounting change that should be reported in the period of change and future periods if the change affects both.
   b. An accounting change that should be reported by restating the financial statements of all prior periods presented.
   c. A correction of an error.
   d. Not an accounting change.

N82#24. Pro forma effects of retroactive application would usually be reported on the face of the income statement for a change
   a. In the service lives of depreciable assets.
   b. In the salvage value of a depreciable asset.
   c. From the straight-line method of depreciation to the double-declining-balance method.
   d. From presenting statements for individual companies to presenting consolidated statements.
M81#29. How should a change in accounting estimate that is recognized by a change in accounting principle be reported?

<table>
<thead>
<tr>
<th>Change in accounting estimate</th>
<th>Change in accounting principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

D. Nonmonetary Transactions

M82#17. In an arm's-length transaction, Company A and Company B exchanged nonmonetary assets with no monetary consideration involved. The exchange did culminate an earning process for both Company A and Company B, and the fair values of the nonmonetary assets were both clearly evident. The accounting for the exchange should be based on the

a. Fair value of the asset surrendered.

b. Fair value of the asset received.

c. Recorded amount of the asset surrendered.

d. Recorded amount of the asset received.

E. Business Combinations

M85#29. In a business combination accounted for as a purchase, costs of registering equity securities to be issued by the acquiring company are a (an)

a. Expense of the combined company for the period in which the costs were incurred.

b. Direct addition to stockholders’ equity of the combined company.

c. Reduction of the otherwise determinable fair value of the securities.

d. Addition to goodwill.

N84#41. A supportive argument for the pooling of interests method of accounting for a business combination is that

a. It was developed within the boundaries of the historical-cost system and is compatible with it.

b. One company is clearly the dominant and continuing entity.

c. Goodwill is generally a part of any acquisition.

d. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.

N83#33. On November 1, 1982, Company X acquired all of the outstanding common stock of Company Y in a business combination accounted for as a pooling of interests. Both companies have a December 31 year end and have been in business for many years. Consolidated net income for the year ended December 31, 1982, should include net income for 12 months of

<table>
<thead>
<tr>
<th>Company X</th>
<th>Company Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N83#34. In order to report a business combination as a pooling of interests, the minimum amount of an investee’s common stock which must be acquired during the combination period in exchange for the investor’s common stock is

a. 100 percent.

b. 51 percent.

c. 80 percent.

d. 90 percent.

M83#41. In a business combination how should plant and equipment of the acquired corporation generally be reported under each of the following methods?

<table>
<thead>
<tr>
<th>Pooling of interests</th>
<th>Purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Fair value</td>
<td>Recorded value</td>
</tr>
<tr>
<td>b. Fair value</td>
<td>Fair value</td>
</tr>
<tr>
<td>c. Recorded value</td>
<td>Recorded value</td>
</tr>
<tr>
<td>d. Recorded value</td>
<td>Fair value</td>
</tr>
</tbody>
</table>

N82#31. Company X acquired for cash all of the outstanding common stock of Company Y. How should Company X determine in general the amounts to be reported for the inventories and long-term debt acquired from Company Y?

<table>
<thead>
<tr>
<th>Inventories</th>
<th>Long-term debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Fair value</td>
<td>Fair value</td>
</tr>
<tr>
<td>b. Fair value</td>
<td>Recorded value</td>
</tr>
<tr>
<td>c. Recorded value</td>
<td>Fair value</td>
</tr>
<tr>
<td>d. Recorded value</td>
<td>Recorded value</td>
</tr>
</tbody>
</table>

N82#35. Costs incurred in effecting a business combination accounted for as a pooling of interests should be

a. Added to the cost of the investment account of the parent corporation.

b. Deducted from additional paid-in capital of the combined corporation.

c. Deducted in determining net income of the combined corporation for the period in which the costs were incurred.

d. Capitalized and subsequently amortized over a period not exceeding forty years.

M82#30. Which of the following is the appropriate basis for valuing fixed assets acquired in a business
Selected Questions

combination accounted for as a purchase carried out by exchanging cash for common stock?

a. Historic cost.
   b. Book value.
   c. Cost plus any excess of purchase price over book value of asset acquired.
   d. Fair value.

M81#31. How should long-term debt assumed in a business combination be shown under each of the following methods?

<table>
<thead>
<tr>
<th>Purchase</th>
<th>Pooling of interests</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Recorded value</td>
<td>Recorded value</td>
</tr>
<tr>
<td>b. Recorded value</td>
<td>Fair value</td>
</tr>
<tr>
<td>c. Fair value</td>
<td>Fair value</td>
</tr>
<tr>
<td>d. Fair value</td>
<td>Recorded value</td>
</tr>
</tbody>
</table>

F. Interim Financial Statements

M85#30. Property taxes may be accrued or deferred to provide an appropriate cost in each period for

<table>
<thead>
<tr>
<th>Interim financial reporting</th>
<th>Year-end financial reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N84#42. 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. This effective tax rate should reflect anticipated

<table>
<thead>
<tr>
<th>Capital gains</th>
<th>Investment tax credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N83#35. For external reporting purposes, it is appropriate to use estimated gross profit rates to determine the cost of goods sold for

<table>
<thead>
<tr>
<th>Interim financial reporting</th>
<th>Year-end financial reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N82#32. An inventory loss from a market decline occurred in the first quarter that was not expected to be restored in the fiscal year. For interim financial reporting purposes, how would the dollar amount of inventory in the balance sheet be affected in the first and fourth quarters?

<table>
<thead>
<tr>
<th>First quarter</th>
<th>Fourth quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M82#38. For interim financial reporting, an inventory loss from a market decline in the second quarter that is not expected to be restored in the fiscal year should be recognized as a loss

a. In the fourth quarter.
b. Proportionately in each of the second, third, and fourth quarters.
c. Proportionately in each of the first, second, third, and fourth quarters.
d. In the second quarter.

N81#36. If annual major repairs made in the first quarter and paid for in the second quarter clearly benefit the entire year, when should they be expensed?

a. An allocated portion in each of the last three quarters.
b. An allocated portion in each quarter of the year.
c. In full in the first quarter.
d. In full in the second quarter.

M81#32. For interim financial reporting, an inventory loss from a temporary market decline in the first quarter which can reasonably be expected to be restored in the fourth quarter

a. Should be recognized as a loss proportionately in each of the first, second, third, and fourth quarters.
b. Should be recognized as a loss proportionately in each of the first, second, and third quarters.
c. Need not be recognized as a loss in the first quarter.
d. Should be recognized as a loss in the first quarter.

G. Gain Contingencies

M81#36. Gain contingencies are usually recognized in the income statement when

a. Realized.
b. Occurrence is reasonably possible and the amount can be reasonably estimated.
c. Occurrence is probable and the amount can be reasonably estimated.
d. The amount can be reasonably estimated.
H. Segments and Lines of Business

M85#31. In Logan Company's financial reporting for segments of a business enterprise, which of the following assets should be included as an identifiable asset of the textile mill product industry segment?
   a. A loan from the textile mill product segment to another industry segment.
   b. An investment by the textile mill product segment in another industry segment.
   c. An allocated portion of assets maintained for general corporate purposes and not used in the operations of the textile mill product segment.
   d. An allocated portion of intangible assets used jointly by the textile mill product segment and another industry segment.

M84#33. In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include
   a. Income taxes.
   b. Expenses that relate to revenue from intersegment transfers.
   c. Equity in income from unconsolidated subsidiaries.
   d. General corporate expenses.

M83#44. In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include

<table>
<thead>
<tr>
<th>Reasonably allocated common operating costs</th>
<th>Traceable operating costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M82#2. When reporting the loss on disposal of a segment of a business which is to be abandoned, an estimated amount for operating losses during the phaseout period should
   a. Be included in the income statement as part of the loss on disposal of the discontinued segment.
   b. Be included in the income statement as part of the income (loss) from operations of the discontinued segment.
   c. Be included in the income statement as part of the income (loss) from continuing operations.
   d. Not be included in the income statement.

N81#40. In financial reporting for segments of a business enterprise, which of the following assets should be included as an identifiable asset of industry segment A?
   a. An intangible asset used by industry segment A.
   b. An advance from nonfinancial industry segment A to another industry segment.
   c. An allocation of a tangible asset used for general corporate purposes, and not used in the operations of any particular industry segment.
   d. An allocation of a tangible asset used by another industry segment which transfers products to industry segment A.

M81#39. In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include among other items
   a. Traceable costs.
   b. Foreign income taxes.
   c. Extraordinary items.
   d. Loss on discontinued operations.

I. Employee Benefits

M85#34. In determining whether to accrue employee's compensation for future absences, among the conditions that must be met are that the obligation relates to rights that

<table>
<thead>
<tr>
<th>Accumulate</th>
<th>Vest</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N84#44. For a compensatory stock option plan for which the date of grant and the measurement date are different, the stock options outstanding account should be reduced at the
   a. Date of grant.
   b. Measurement date.
   c. Adoption date of the plan.
   d. Exercise date.

M83#42. In accounting for the cost of pension plans, an acceptable actuarial cost method for financial reporting purposes is
   a. Pay-as-you-go.
   b. Unit credit.
   c. Turnover.
   d. Terminal funding.

N82#39. For its defined benefit pension plans, an employer should disclose for each complete set of financial statements, as of the most recent benefit information date for which the data are available, the actuarial present value of accumulated plan benefits that are

<table>
<thead>
<tr>
<th>Vested</th>
<th>Nonvested</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M82#35. If the stock for a compensatory stock option plan is issued before some or all of the services are performed, a part of the consideration recorded for the
stock issued is unearned compensation and should be shown in the balance sheet as a line item in
a. Noncurrent liabilities.
b. Stockholders' equity.
c. Current assets.
d. Noncurrent assets.

M81#37. APB Opinion No. 8 sets minimum and maximum limits on the annual provision for pension cost. An amount that is always included in the calculation of both the minimum and maximum limit is
a. Normal cost.
b. Amortization of past service cost.
c. Interest on unfunded past and prior service costs.
d. Retirement benefits paid.

M81#38. For a compensatory stock option plan for which the date of the grant and the measurement date are the same, what account is credited at the date of the grant?
   a. Retained earnings.
b. Stock options outstanding.
c. Deferred compensation cost.
d. Compensation expense.

J. Analysis of Financial Statements

M85#35. How are dividends per share for common stock used in the calculation of the following?

<table>
<thead>
<tr>
<th>Dividend per-share payout ratio</th>
<th>Earnings per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Numerator</td>
<td>Not used</td>
</tr>
<tr>
<td>c. Numerator</td>
<td>Not used</td>
</tr>
<tr>
<td>d. Numerator</td>
<td>Numerator</td>
</tr>
</tbody>
</table>

M84#45. How are earnings per share used in the calculation of the following?

<table>
<thead>
<tr>
<th>Dividend per-share payout ratio</th>
<th>Price-earnings ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Denominator</td>
<td>Numerator</td>
</tr>
<tr>
<td>c. Not used</td>
<td>Denominator</td>
</tr>
<tr>
<td>d. Denominator</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

M84#35. How is the average inventory used in the calculation of each of the following?

<table>
<thead>
<tr>
<th>Acid test (quick ratio)</th>
<th>Inventory turnover rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Numerator</td>
<td>Denominator</td>
</tr>
<tr>
<td>c. Not used</td>
<td>Denominator</td>
</tr>
<tr>
<td>d. Not used</td>
<td>Numerator</td>
</tr>
</tbody>
</table>

M84#45. Inventories would be included in the calculation of which of the following?

M82#40. How are the following used in the calculation of the dividend payout ratio for a company with only common stock outstanding?

<table>
<thead>
<tr>
<th>Dividends per share</th>
<th>Earnings per share</th>
<th>Book value per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Denominator</td>
<td>Numerator</td>
<td>Not used</td>
</tr>
<tr>
<td>b. Denominator</td>
<td>Not used</td>
<td>Numerator</td>
</tr>
<tr>
<td>c. Numerator</td>
<td>Denominator</td>
<td>Not used</td>
</tr>
<tr>
<td>d. Numerator</td>
<td>Not used</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

M81#39. What is the effect of the collection of accounts receivable on the current ratio and net working capital, respectively?

<table>
<thead>
<tr>
<th>Current ratio</th>
<th>Net working capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>Increase</td>
</tr>
</tbody>
</table>

M81#30. Which of the following is an appropriate computation for return on investment?

   a. Income divided by total assets.
b. Income divided by sales.
c. Sales divided by total assets.
d. Sales divided by stockholders' equity.

M81#40. Which of the following accounts would be included in the calculation of the acid test (quick) ratio?

<table>
<thead>
<tr>
<th>Accounts receivable</th>
<th>Inventories</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

L. Personal Financial Statements

M85#33. Personal financial statements should present
   a. Assets and liabilities at their historical cost.
b. Assets at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements.
c. Assets at their estimated current values at the date of the financial statements and liabilities at their historical cost.
d. Assets and liabilities at their historical cost and, as additional information, at their estimated current values.
VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

M85#36. The variable portion of the semivariable cost of electricity for a manufacturing plant is a

<table>
<thead>
<tr>
<th>Conversion cost</th>
<th>Period cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M85#37. The cost of fire insurance for a manufacturing plant is generally a

a. Nonmanufacturing cost.
b. Period cost.
c. Semivariable cost.
d. Conversion cost.

N84#46. Prime cost and conversion cost share what common element of total cost?

a. Direct materials.
b. Direct labor.
c. Variable overhead.
d. Fixed overhead.

N84#47. In developing a factory overhead application rate for use in a process costing system, which of the following could be used in the denominator?

a. Actual factory overhead.
b. Estimated factory overhead.
c. Actual direct labor hours.
d. Estimated direct labor hours.

N84#48. Indirect labor is a

a. Nonmanufacturing cost.
b. Conversion cost.
c. Prime cost.
d. Period cost.

M84#39. The fixed portion of the semivariable cost of electricity for a manufacturing plant is a

<table>
<thead>
<tr>
<th>Conversion cost</th>
<th>Product cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N83#36. Wages paid to factory machine operators of a manufacturing plant are an element of

<table>
<thead>
<tr>
<th>Prime cost</th>
<th>Conversion cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N83#37. Property taxes on a manufacturing plant are an element of

<table>
<thead>
<tr>
<th>Conversion cost</th>
<th>Period cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N83#38. Factory supplies for a manufacturing plant are generally

a. Prime costs.
b. Period costs.
c. Variable costs.
d. Excluded from product costs.

M83#46. Supervisory salaries for a manufacturing plant would be an example of which of the following?

<table>
<thead>
<tr>
<th>Prime cost</th>
<th>Conversion cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N82#42. Wages of the security guard for a small plant would be an example of

<table>
<thead>
<tr>
<th>Indirect labor</th>
<th>Fixed factory overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N81#41. Indirect materials are a (an)

a. Prime cost.
b. Fixed cost.
Selected Questions

c. Irrelevant cost.
d. Factory overhead cost.

N81#42. Factory overhead
a. Is a prime cost.
b. Can be a variable cost or a fixed cost.
c. Can only be a fixed cost.
d. Includes all factory labor.

N81#46. Direct materials are a

<table>
<thead>
<tr>
<th>Conversion cost</th>
<th>Manufacturing cost</th>
<th>Prime cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

M81#41. For a manufacturing company, which of the following is an example of a period rather than a product cost?

a. Depreciation on factory equipment.
b. Wages of salespersons.
c. Wages of machine operators.
d. Insurance on factory equipment.

M81#43. In order to identify costs that relate to a specific product, an allocation base should be chosen that

a. Does not have a cause and effect relationship.
b. Has a cause and effect relationship.
c. Considers variable costs but not fixed costs.
d. Considers direct materials and direct labor but not factory overhead.

B. Process and Job Order Costing

M85#38. In a job order cost system, the use of indirect materials would usually be reflected in the general ledger as an increase in

a. Stores control.
b. Work in process control.
c. Factory overhead control.
d. Factory overhead applied.

M85#41. When using the first-in, first-out method of process costing, total equivalent units of production for a given period of time is equal to the number of units.

a. In work in process at the beginning of the period times the percent of work necessary to complete the items, plus the number of units started during the period, less the number of units remaining in work in process at the end of the period times the percent of work necessary to complete the items.
b. In work in process at the beginning of the period, plus the number of units started during the period, plus the number of units remaining in work in process at the end of the period times the percent of work necessary to complete the items.

c. Started into process during the period, plus the number of units in work in process at the beginning of the period.
d. Transferred out during the period, plus the number of units remaining in work in process at the end of the period times the percent of work necessary to complete the items.

N84#49. In a given process costing system, the equivalent units of production are computed using the weighted-average method. With respect to conversion costs, the percentage of completion for the current period only is included in the calculation of the

<table>
<thead>
<tr>
<th>Beginning work in process inventory</th>
<th>Ending work in process inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#36. In a job order cost system, the incurring of indirect labor costs would usually be included in the general ledger as a charge to

a. Factory department overhead control.
b. Factory overhead applied.
c. Work in process control.
d. Accrued payroll.

M84#42. Assuming that there was no beginning work in process inventory, and the ending work in process inventory is 100% complete as to material costs, the number of equivalent units as to material costs would be

a. The same as the units placed in process.
b. The same as the units completed.
c. Less than the units placed in process.
d. Less than the units completed.

N83#39. Accounting for factory overhead costs involves averaging in

<table>
<thead>
<tr>
<th>Job order costing</th>
<th>Process costing</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

T-33
N83#41. In the computation of manufacturing cost per equivalent unit, the weighted-average method of process costing considers
a. Current costs only.
b. Current costs plus cost of ending work in process inventory.
c. Current costs less cost of beginning work in process inventory.
d. Current costs plus cost of beginning work in process inventory.

N82#41. An actual cost system may be used in
a. Neither process costing nor job order costing.
b. Process costing but not job order costing.
c. Job order costing but not process costing.
d. Both job order costing and process costing.

N82#43. The percentage of completion of the beginning work-in-process inventory should be included in the computation of the equivalent units of production for which of the following methods of process costing?

<table>
<thead>
<tr>
<th>First-in, first-out</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M82#41. In job order costing, what journal entry should be made for the return to the storekeeper of direct materials previously issued to the factory for use on a particular job?

<table>
<thead>
<tr>
<th>First-in, first-out</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Debit materials and credit factory overhead.</td>
<td></td>
</tr>
<tr>
<td>b. Debit materials and credit work in process.</td>
<td></td>
</tr>
<tr>
<td>c. Debit purchase returns and credit work in process.</td>
<td></td>
</tr>
<tr>
<td>d. Debit work in process and credit materials.</td>
<td></td>
</tr>
</tbody>
</table>

M82#42. The beginning work in process inventory was 60 percent complete as to conversion costs, and the ending work in process inventory was 45 percent complete as to conversion costs. The dollar amount of the conversion cost included in the ending work in process inventory (using the weighted-average method) is determined by multiplying the average unit conversion costs by what percentage of the total units in the ending work in process inventory?

<table>
<thead>
<tr>
<th>First-in, first-out</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 100 percent.</td>
<td></td>
</tr>
<tr>
<td>b. 60 percent.</td>
<td></td>
</tr>
<tr>
<td>c. 55 percent.</td>
<td></td>
</tr>
<tr>
<td>d. 45 percent.</td>
<td></td>
</tr>
</tbody>
</table>

N81#43. Purchased materials are added in the second department of a three-department process; this increases the number of units produced in the second department and would always

<table>
<thead>
<tr>
<th>First-in, first-out</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Change the direct labor cost percentage in the ending work-in-process inventory.</td>
<td></td>
</tr>
</tbody>
</table>

b. Cause no adjustment to the unit cost transferred in from the first department.
c. Increase total unit costs.
d. Decrease total ending work-in-process inventory.

N81#44. A nonmanufacturing organization may use
a. Job order costing but not process costing.
b. Process costing but not job order costing.
c. Either job order costing or process costing.
d. Neither job order costing nor process costing.

N81#45. Purchased materials are added in the second department of a three-department process; this does not increase the number of units produced in the second department and would

<table>
<thead>
<tr>
<th>First-in, first-out</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Not change the dollar amount transferred to the next department.</td>
<td></td>
</tr>
<tr>
<td>b. Decrease total work-in-process inventory.</td>
<td></td>
</tr>
<tr>
<td>c. Increase the factory overhead portion of the ending work-in-process inventory.</td>
<td></td>
</tr>
<tr>
<td>d. Increase total unit cost.</td>
<td></td>
</tr>
</tbody>
</table>

M81#44. What is the best cost accumulation procedure to use when many batches, each differing as to product specifications, are produced?

<table>
<thead>
<tr>
<th>First-in, first-out</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Job order.</td>
<td></td>
</tr>
<tr>
<td>c. Actual.</td>
<td></td>
</tr>
<tr>
<td>d. Standard.</td>
<td></td>
</tr>
</tbody>
</table>

M81#46. The units transferred in from the first department to the second department should be included in the computation of the equivalent units for the second department for which of the following methods of process costing?

<table>
<thead>
<tr>
<th>First-in, first-out</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

C. Standard Costing

M85#39. Under the three-variance method for analyzing factory overhead, the difference between the actual factory overhead and the factory overhead applied to production is the

<table>
<thead>
<tr>
<th>First-in, first-out</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Net overhead variance.</td>
<td></td>
</tr>
<tr>
<td>b. Controllable variance.</td>
<td></td>
</tr>
<tr>
<td>c. Efficiency variance.</td>
<td></td>
</tr>
<tr>
<td>d. Spending variance.</td>
<td></td>
</tr>
</tbody>
</table>

M85#40. Under the two-variance method for analyzing factory overhead, the budget allowance based on
standard hours allowed is used in the computation of the

<table>
<thead>
<tr>
<th>Controllable (budget) variance</th>
<th>Volume variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**N83#43.** Under the three-variance method for analyzing factory overhead, which of the following is used in the computation of the spending variance?

<table>
<thead>
<tr>
<th>Actual factory overhead</th>
<th>Factory overhead applied to production</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**N84#50.** If a company follows a practice of isolating variances at the earliest point in time, what would be the appropriate time to isolate and recognize a direct material price variance?

a. When material is issued.

b. When material is purchased.

c. When material is used in production.

d. When purchase order is originated.

**N82#51.** Under the three-variance method for analyzing factory overhead, the difference between the actual factory overhead and the budget allowance based on actual hours is the

a. Efficiency variance.

b. Spending variance.

c. Volume variance.

d. Idle capacity variance.

**M84#43.** A standard cost system may be used in

a. Job order costing but not process costing.

b. Either job order costing or process costing.

c. Process costing but not job order costing.

d. Neither process costing nor job order costing.

**N84#44.** Under the three-variance method for analyzing factory overhead, which of the following is used in the computation of the spending variance?

<table>
<thead>
<tr>
<th>Budget allowance based on actual hours</th>
<th>Budget allowance based on standard hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**N83#42.** Under the two-variance method for analyzing factory overhead, the volume variance is the difference between the

a. Budget allowance based on standard hours allowed and the budget allowance based on actual hours worked.

b. Budget allowance based on standard hours allowed and the factory overhead applied to production.

c. Actual factory overhead and the budget allowance based on standard hours allowed.

d. Actual factory overhead and the factory overhead applied to production.

**N84#52.** An unfavorable labor efficiency variance connotes that

a. The actual labor rate was higher than the standard labor rate.

b. The total labor variance must also be unfavorable.

c. Actual labor hours worked exceeded standard labor hours for the production level achieved.

d. Overtime labor was used during the period.

**N81#53.** Which of the following unfavorable variances would be directly affected by the relative position of a production process on a learning curve?

a. Materials mix.

b. Materials price.

c. Labor rate.

d. Labor efficiency.
M81#50. Which department is customarily held responsible for an unfavorable materials usage variance?
   a. Quality control.
   b. Purchasing.
   c. Engineering.
   d. Production.

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

M85#50. Byproducts
   a. Have relatively more sales value than joint products.
   b. Have relatively less sales value than scrap.
   c. Occur before the split-off point.
   d. Are often subject to additional costs beyond the split-off point.

N84#52. For purposes of allocating joint costs to joint products using the relative sales value at split-off method, the costs beyond split-off
   a. Are allocated in the same manner as the joint costs.
   b. Are deducted from the relative sales value at split-off.
   c. Are deducted from the sales value at point of sale.
   d. Do not affect the allocation of the joint costs.

M84#45. For purposes of allocating joint costs to joint products, the sales price at point of sale reduced by cost to complete after split-off is assumed to be equal to the
   a. Relative sales value at split-off.
   b. Sales price less a normal profit margin at point of sale.
   c. Joint costs.
   d. Total costs.

N82#44. Relative sales value at split-off is used to allocate

   Costs beyond split-off
   a. Yes
   b. Yes
   c. No
   d. No

   Joint costs
   a. Yes
   b. No
   c. Yes
   d. No

M82#44. For purposes of allocating joint costs to joint products, the relative sales value at split-off method could be used in which of the following situations?

   No costs beyond split-off
   a. Yes
   b. Yes
   c. No
   d. No

   Costs beyond split-off
   a. Yes
   b. No
   c. No
   d. No

N81#48. For purposes of allocating joint costs to joint products, the relative sales value at split-off is equal to
   a. Sales price less a normal profit margin at point of sale.
   b. Sales price at point of sale reduced by cost to complete after split-off.
   c. Total sales value less joint costs at point of split-off.
   d. Separable product cost plus a normal profit margin.

N81#49. At the split-off point, products may be salable or may require further processing in order to be salable. Which of the following have both of these characteristics?

   By-products
   a. No
   b. No
   c. Yes
   d. Yes

   Joint products
   a. No
   b. Yes
   c. No
   d. Yes

N81#57. Which of the following is an inventorable cost?

   Abnormal spoilage
   a. No
   b. No
   c. Yes
   d. Yes

   Normal spoilage
   a. No
   b. Yes
   c. No
   d. Yes

M81#48. Joint costs are most frequently allocated based upon relative
   a. Profitability.
   b. Conversion costs.
   c. Prime costs.
   d. Sales value.

M81#49. Under an acceptable method of costing by-products, inventory costs of the by-product are based on the portion of the joint production cost allocated to the by-product
   a. But any subsequent processing cost is debited to the cost of the main product.
   b. But any subsequent processing cost is debited to revenue of the main product.
   c. Plus any subsequent processing cost.
   d. Less any subsequent processing cost.
Selected Questions

E. Absorption and Variable Costing

M85#42. In an income statement prepared as an internal report using the direct (variable) costing method, fixed selling and administrative expenses 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 selling and administrative expenses.

M84#53. An allocated portion of fixed factory overhead is included in work in process inventory under

<table>
<thead>
<tr>
<th>Absorption costing</th>
<th>Direct (variable) costing</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#46. If an income statement is prepared as an internal report, under which of the following methods would the term gross profit most likely appear?
   a. Both absorption costing and direct (variable) costing.
   b. Absorption costing but not direct (variable) costing.
   c. Direct (variable) costing but not absorption costing.
   d. Neither direct (variable) costing nor absorption costing.

M83#44. The direct (variable) costing method includes in inventory
   a. Direct materials cost, direct labor cost, but no factory overhead cost.
   b. Direct materials cost, direct labor cost, and variable factory overhead cost.
   c. Prime cost but not conversion cost.
   d. Prime cost and all conversion cost.

M83#47. Operating income using direct costing as compared to absorption costing would be higher
   a. When the quantity of beginning inventory equals the quantity of ending inventory.
   b. When the quantity of beginning inventory is more than the quantity of ending inventory.
   c. When the quantity of beginning inventory is less than the quantity of ending inventory.
   d. Under no circumstances.

M82#43. When using full absorption costing, what costs attendant to an element of production (material, labor, or overhead) are used in order to compute variances from standard amounts?
   a. Controllable costs.
   b. Total costs.
   c. Variable costs.
   d. Fixed costs.

M82#45. An income statement is prepared as an internal report. Under which of the following methods would the term contribution margin appear?

<table>
<thead>
<tr>
<th>Absorption costing</th>
<th>Direct costing</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M81#47. What factor, related to manufacturing costs, causes the difference in net earnings computed using absorption costing and net earnings computed using direct costing?
   a. Absorption costing considers all costs in the determination of net earnings, whereas direct costing considers only direct costs.
   b. Absorption costing allocates fixed costs between cost of goods sold and inventories, and direct costing considers all fixed costs to be period costs.
   c. Absorption costing "inventories" all direct costs, but direct costing considers direct costs to be period costs.
   d. Absorption costing "inventories" all fixed costs for the period in ending finished goods inventory, but direct costing expenses all fixed costs.

F. Budgeting and Flexible Budgeting

M85#43. A flexible budget is
   a. Not appropriate when costs and expenses are affected by fluctuations in volume limits.
   b. Appropriate for any relevant level of activity.
   c. Appropriate for control of factory overhead but not for control of direct materials and direct labor.
   d. Appropriate for control of direct materials and direct labor but not for control of factory overhead.

M84#54. When production levels are expected to decline within a relevant range, and a flexible budget is used, what effects would be anticipated with respect to each of the following?

<table>
<thead>
<tr>
<th>Fixed costs per unit</th>
<th>Variable costs per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Increase</td>
<td>No change</td>
</tr>
<tr>
<td>c. No change</td>
<td>No change</td>
</tr>
<tr>
<td>d. No change</td>
<td>Increase</td>
</tr>
</tbody>
</table>
Accounting Theory

MB4#40. A flexible budget is appropriate for a

<table>
<thead>
<tr>
<th>Direct-labor budget</th>
<th>Marketing budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N82#46. When using a flexible budget, what will occur to fixed costs (on a per unit basis) as production increases within the relevant range?
   a. Fixed costs are not considered in flexible budgeting.
   b. Fixed costs per unit will decrease.
   c. Fixed costs per unit will increase.
   d. Fixed costs per unit will remain unchanged.

N81#51. Controllable costs for responsibility accounting purposes are those costs that are directly influenced by
   a. A given manager within a given period of time.
   b. A change in activity.
   c. Production volume.
   d. Sales volume.

G. Breakeven and Cost-Volume-Profit Analysis

MB5#44. How would the following be used in calculating the expected sales level expressed in units?

<table>
<thead>
<tr>
<th>Contribution</th>
<th>Estimated</th>
</tr>
</thead>
<tbody>
<tr>
<td>margin per unit</td>
<td>operating loss</td>
</tr>
<tr>
<td>a. Denominator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>c. Not Used</td>
<td>Denominator</td>
</tr>
<tr>
<td>d. Numerator</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

N84#55. To obtain the breakeven point stated in terms of dollars of sales, total fixed costs are divided by which of the following?
   a. Variable cost per unit.
   b. Variable cost per unit + sales price per unit.
   c. Fixed cost per unit.
   d. (Sales price per unit – variable cost per unit) ÷ sales price per unit.

N84#56. Breakeven analysis assumes linearity over the relevant range with respect to

<table>
<thead>
<tr>
<th>Total costs</th>
<th>Total revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

MB4#47. The contribution margin ratio always increases when the
   a. Breakeven point increases.
   b. Breakeven point decreases.

c. Variable costs as a percentage of net sales decrease.
d. Variable costs as a percentage of net sales increase.

MB4#48. In using cost-volume-profit analysis to calculate the expected sales level expressed in units, a predicted operating loss would be
   a. Added to fixed costs in the numerator.
   b. Added to fixed costs in the denominator.
   c. Subtracted from fixed costs in the numerator.
   d. Subtracted from fixed costs in the denominator.

N83#45. How would the following be used in calculating sales necessary to realize a projected profit?

<table>
<thead>
<tr>
<th>Projected profit</th>
<th>Contribution margin ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Denominator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Denominator</td>
<td>Not used</td>
</tr>
<tr>
<td>c. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>d. Numerator</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

N83#46. The contribution margin decreases when sales volume remains the same and
   a. Fixed costs increase.
   b. Fixed costs decrease.
   c. Variable cost per unit increases.
   d. Variable cost per unit decreases.

M82#47. How may the following be used in calculating the breakeven point in units?

<table>
<thead>
<tr>
<th>Fixed costs</th>
<th>Contribution margin per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Denominator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Denominator</td>
<td>Not used</td>
</tr>
<tr>
<td>c. Numerator</td>
<td>Not used</td>
</tr>
<tr>
<td>d. Numerator</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

M82#50. The contribution margin increases when sales volume remains the same and
   a. Variable cost per unit decreases.
   b. Variable cost per unit increases.
   c. Fixed costs decrease.
   d. Fixed costs increase.

N81#50. At the breakeven point, fixed cost is always
   a. Less than the contribution margin.
   b. Equal to the contribution margin.
   c. More than the contribution margin.
   d. More than the variable cost.

N81#56. The dollar amount of sales needed to attain a desired profit is calculated by dividing the contribution margin ratio into
   a. Fixed cost.
   b. Desired profit.
   c. Desired profit plus fixed cost.
   d. Desired profit less fixed cost.
H. Capital Budgeting Techniques

**M85#45.** On May 1, 1985, a company purchased a new machine which it does not have to pay for until May 1, 1987. The total payment on May 1, 1987, 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. Future amount of annuity of 1.
- b. Future amount of 1.
- c. Present value of annuity of 1.
- d. Present value of 1.

**M85#46.** It is assumed that cash flows are reinvested at the rate earned by the investment in which of the following capital budgeting techniques?

<table>
<thead>
<tr>
<th>Internal rate of return</th>
<th>Net present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**M84#57.** A proposed project has an expected economic life of eight years. In the calculation of the net present value of the proposed project, salvage value would be

- a. Excluded from the calculation of the net present value.
- b. Included as a cash inflow at the estimated salvage value.
- c. Included as a cash inflow at the present value of the estimated salvage value.
- d. Included as a cash inflow at the future amount of the estimated salvage value.

**M84#59.** If income tax considerations are ignored, how is depreciation expense used in the following capital budgeting techniques?

<table>
<thead>
<tr>
<th>Internal rate of return</th>
<th>Payback</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Excluded</td>
<td>Excluded</td>
</tr>
<tr>
<td>b. Excluded</td>
<td>Included</td>
</tr>
<tr>
<td>c. Included</td>
<td>Excluded</td>
</tr>
<tr>
<td>d. Included</td>
<td>Included</td>
</tr>
</tbody>
</table>

**M84#41.** Under the internal rate of return capital budgeting technique, it is assumed that cash flows are reinvested at the:

- a. Cost of capital.
- b. Hurdle rate of return.
- c. Rate earned by the investment.
- d. Payback rate.

**M83#48.** Which of the following capital budgeting techniques consider(s) cash flow over the entire life of the project?

<table>
<thead>
<tr>
<th>Internal rate of return</th>
<th>Payback</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**M82#46.** Which of the following capital budgeting techniques require(s) the use of cash flows from period to period?

<table>
<thead>
<tr>
<th>Internal rate of return</th>
<th>Net present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**M82#49.** How are the following used in the calculation of the net present value of a proposed project? Ignore income tax considerations.

<table>
<thead>
<tr>
<th>Depreciation expense</th>
<th>Salvage value</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Include</td>
<td>Include</td>
</tr>
<tr>
<td>b. Include</td>
<td>Exclude</td>
</tr>
<tr>
<td>c. Exclude</td>
<td>Include</td>
</tr>
<tr>
<td>d. Exclude</td>
<td>Exclude</td>
</tr>
</tbody>
</table>

**M81#60.** The minimum return that a project must earn for a company in order to leave the value of the company unchanged is the

- b. Discount rate.
- c. Capitalization rate.
- d. Cost of capital.

I. Performance Analysis

**M85#47.** The invested capital-employed turnover rate would include

- a. Net income in the numerator.
- b. Net income in the denominator.
- c. Sales in the numerator.
- d. Sales in the denominator.

**M84#60.** Assuming that sales and net income remain the same, a company's return on investment would

- a. Increase if the invested capital-employed turnover rate decreases.
- b. Increase if the invested capital-employed turnover rate increases.
- c. Increase if invested capital increases.
- d. Decrease if invested capital decreases.
M83#49. A company’s return on investment (ROI) would generally increase when
   a. Assets increase.
   b. Selling prices decrease.
   c. Costs decrease.
   d. Costs increase.

J. Other

M85#48. Multiple regression analysis
   a. Establishes a cause and effect relationship.
   b. Is not a sampling technique.
   c. Involves the use of independent variables only.
   d. Produces measures of probable error.

M85#49. Which of the following would be included in the economic order quantity formula?

<table>
<thead>
<tr>
<th>Inventory carrying cost</th>
<th>Stockout cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M84#49. A company is deciding whether to exchange an old asset for a new asset. Within the context of the exchange decision, and ignoring income tax considerations, the undepreciated book balance of the old asset would be considered (an)

<table>
<thead>
<tr>
<th>Sunk cost</th>
<th>Irrelevant cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M83#50. Simple regression analysis
   a. Establishes a cause and effect relationship.
   b. Produces measures of probable error.
   c. Involves the use of independent variables only.
   d. Involves the use of more than two variables.

M83#50. The economic order quantity formula can be used to determine the optimum size of a production run if it minimizes the annual inventory cost which is comprised of ordering cost and

<table>
<thead>
<tr>
<th>Production run</th>
<th>Purchase order</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N82#47. Multiple regression analysis
   a. Establishes a cause and effect relationship.
   b. Does not produce measures of probable error.
   c. Measures the change in one variable associated with the change in one other variable.
   d. Measures the change in one variable associated with the change in more than one other variable.

N82#49. The order size determined by the economic order quantity formula minimizes the annual inventory cost which is comprised of ordering cost and

| a. Safety-stock cost. |
| b. Stock-out cost.    |
| c. Set-up cost.       |
| d. Carrying cost.     |

N81#54. Which of the following could be determined by using the economic order quantity formula?

| a. Optimum size of a production run. |
| b. Safety stock.                     |
| c. Stock-out cost.                   |
| d. Order point.                      |

N81#58. Probability (risk) analysis
   a. Ignores probability weights under fifty percent.
   b. Is only for situations in which there are three or fewer possible outcomes.
   c. Does not enhance the usefulness of sensitivity analysis data.
   d. Is an extension of sensitivity analysis.
Selected Questions

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework

M85#51. Under the modified accrual basis of accounting for a governmental unit, revenues should be recognized in the accounting period in which they
   a. Become available and earned.
   b. Become available and measurable.
   c. Are earned and become measurable.
   d. Are collected.

B. Fund Accounting

M85#52. The appropriations control account of a governmental unit is debited when
   a. The budgetary accounts are closed.
   b. The budget is recorded.
   c. Supplies are purchased.
   d. Expenditures are recorded.

M85#53. Which of the following accounts of a governmental unit is credited when a purchase order is approved?
   a. Encumbrances control.
   b. Fund balance reserved for encumbrances.
   c. Vouchers payable.
   d. Appropriations control.

M84#51. When the budget of a governmental unit is adopted and the estimated revenues exceed the appropriations, the excess is
   a. Credited to fund balance.
   b. Debited to fund balance.
   c. Credited to reserve for encumbrances.
   d. Debited to reserve for encumbrances.

M84#52. The estimated revenues account of a governmental unit is credited when
   a. The budget is closed out at the end of the year.
   b. The budget is recorded.
   c. Property taxes are recorded.
   d. Property taxes are collected.

M84#53. When supplies ordered by a governmental unit are received at an actual price which is less than the estimated price on the purchase order, the encumbrance account is
   a. Credited for the estimated price on the purchase order.
   b. Credited for the actual price for the supplies received.
   c. Debited for the estimated price on the purchase order.
   d. Debited for the actual price for the supplies received.

M83#51. Which of the following accounts of a governmental unit is credited when the budget is recorded?
   a. Encumbrances.
   b. Reserve for encumbrances.
   c. Estimated revenues.
   d. Appropriations.

M83#52. Which of the following accounts of a governmental unit is debited when supplies previously ordered are received?
   a. Encumbrances.
   b. Reserve for encumbrances.
   c. Vouchers payable.
   d. Appropriations.

M83#53. When fixed assets purchased from general fund revenues were received, the appropriate journal entry was made in the general fixed asset account group. What account, if any, should have been debited in the general fund?
   a. No journal entry should have been made in the general fund.
   b. Fixed assets.
   c. Expenditures.
   d. Due from general fixed asset account group.

M83#51. Which of the following will increase the fund balance of a governmental unit at the end of the fiscal year?
   a. Appropriations are less than expenditures and reserve for encumbrances.
   b. Appropriations are less than expenditures and encumbrances.
   c. Appropriations are more than expenditures and encumbrances.
   d. Appropriations are more than estimated revenues.

M83#52. Which of the following accounts of a governmental unit is credited to close it out at the end of the fiscal year?
   a. Appropriations.
   b. Revenues.
   c. Reserve for encumbrances.
   d. Encumbrances.

M83#53. Which of the following accounts of a governmental unit is credited when taxpayers are billed for property taxes?
   a. Estimated revenues.
   b. Revenues.
   c. Appropriations.
   d. Reserve for encumbrances.
**Accounting Theory**

**M82#51.** Which of the following accounts of a governmental unit is (are) closed out at the end of the fiscal year?

<table>
<thead>
<tr>
<th>Estimated revenues</th>
<th>Fund balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**M82#53.** Repairs that have been made for a governmental unit, and for which a bill has been received, should be recorded in the general fund as a debit to an
a. Expenditure.
b. Encumbrance.
c. Expense.
d. Appropriation.

**M82#53.** At the end of the fiscal year of a governmental unit, the excess of expenditures and encumbrances over appropriations
a. Increases the fund balance.
b. Decreases the fund balance.
c. Increases the reserve for encumbrances.
d. Decreases the reserve for encumbrances.

**M82#54.** Which of the following accounts of a governmental unit is closed out at the end of the fiscal year?

- Fund balance.
- Reserve for encumbrances.
- Appropriations.
- Vouchers payable.

**M82#55.** The encumbrance account of a governmental unit is debited when

- A purchase order is approved.
- Goods are received.
- A voucher payable is recorded.
- The budget is recorded.

**M81#53.** When goods which have been previously approved for purchase are received by a governmental unit but not yet paid for, what account is credited?

- Reserve for encumbrances.
- Vouchers payable.
- Expenditures.
- Appropriations.

**C. Types of Funds and Fund Accounts**

**M85#54.** The special revenue fund of a governmental unit is an example of what type of fund?

- Governmental.
- Proprietary.
- Internal service.
- Fiduciary.

**M85#55.** Which governmental fund would account for fixed assets in a manner similar to a “for-profit” organization?

- Enterprise.
- Capital projects.
- General fixed asset account group.
- General.

**M85#56.** Which of the following funds of a governmental unit uses the modified accrual basis of accounting?

- Nonexpendable trust.
- Enterprise.
- Internal service.
- Special assessment.

**M85#57.** Fixed assets should be accounted for in the general fixed assets account group for the

<table>
<thead>
<tr>
<th>Capital projects fund</th>
<th>Internal service fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**M84#54.** A capital projects fund of a municipality is an example of what type of fund?

- Internal service.
- Governmental.
- Proprietary.
- Fiduciary.

**M84#55.** Which of the following funds of a governmental unit would account for general long-term debt in the accounts of the fund?

- Special revenue.
- Capital projects.
- Internal service.
- General.
Selected Questions

M84#56. The Amount to be Provided for Retirement of General Long-Term Debt is an account of a governmental unit that would be included in the
a. Asset section of the general long-term debt account group.
b. Asset section of the debt service fund.
c. Liability section of the general long-term debt account group.
d. Liability section of the debt service fund.

M84#57. Customers' meter deposits which can not be spent for normal operating purposes would be classified in the balance sheet of the enterprise fund of a governmental unit as
a. Restricted cash or investments.
b. Nonrestricted cash or investments.
c. Due to general fund.
d. Due to special revenue fund.

N83#54. Which of the following funds of a governmental unit integrates budgetary accounts into the accounting system?
a. Enterprise.
b. Special revenue.
c. Internal service.
d. Nonexpendable trust.

N83#56. Long-term liabilities of an enterprise fund should be accounted for in the

<table>
<thead>
<tr>
<th>Enterprise fund</th>
<th>Long-term debt account group</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N83#57. Fixed assets should be accounted for in the general fixed assets account group for

<table>
<thead>
<tr>
<th>Governmental funds</th>
<th>Proprietary funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M83#55. Which of the following funds of a governmental unit would account for depreciation in the accounts of the fund?
a. General.
b. Internal service.
c. Capital projects.
d. Special assessment.

M83#56. Which of the following funds of a governmental unit uses the same basis of accounting as the special revenue fund?
a. Internal service.
b. Expendable trust.
c. Nonexpendable trust.
d. Enterprise.

M83#57. Which of the following funds of a governmental unit would account for long-term liabilities in the accounts of the fund?
a. Special assessment.
b. Special revenue.
c. Capital projects.
d. Debt service.

M83#58. Which of the following accounts would be included in the asset section of the combined balance sheet of a governmental unit for the general long-term debt account group?

<table>
<thead>
<tr>
<th>Amount available in debt service funds</th>
<th>Amount to be provided for retirement of general long-term debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

N82#54. A debt service fund of a municipality is an example of which of the following types of fund?
a. Fiduciary.
b. Governmental.
c. Proprietary.
d. Internal service.

N82#55. Revenues of a special revenue fund of a governmental unit should be recognized in the period in which the
a. Revenues become available and measurable.
b. Revenues become available for appropriation.
c. Revenues are billable.
d. Cash is received.

N82#56. Which of the following funds of a governmental unit would use the general long-term debt
account group to account for unmatured general long-
term liabilities?
   a. Special assessment.
   b. Capital projects.
   c. Trust.
   d. Internal service.

M82#57. Which of the following funds of a govern-
mental unit uses the same basis of accounting as an enter-
prise fund?
   a. Special revenue.
   b. Internal service.
   c. Expendable trust.
   d. Capital projects.

M82#58. Which of the following funds of a govern-
mental unit could use the general fixed assets account
group to account for fixed assets?
   a. Internal service.
   b. Enterprise.
   c. Trust.
   d. Special assessment.

M82#51. Fixed assets utilized in a city-owned utility
are accounted for in which of the following?

<table>
<thead>
<tr>
<th>Enterprise fund</th>
<th>General fixed assets group of accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M82#52. Which of the following funds of a govern-
mental unit would use the general long-term debt account
group to account for unmatured general long-
term liabilities?
   a. Special assessment.
   b. Trust.
   c. Internal service (intragovernmental service).
   d. Debt service.

M81#56. Which of the following accounts could be
included in the balance sheet of an enterprise fund?

<table>
<thead>
<tr>
<th>Reserve for encumbrances</th>
<th>Revenue bonds payable</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

M81#57. Which of the following accounts would be
included in the combined balance sheet for the long-
term debt account group?
   a. Amount to be provided for retirement of gen-
eral long-term debt.
   c. Reserve for encumbrances.
   d. Cash.

M81#58. Customers’ meter deposits which cannot be
spent for normal operating purposes would be classified
as restricted cash in the balance sheet of which fund?
   a. Internal service (intragovernmental service).
   b. Trust.
   c. Agency.
   d. Enterprise.

D. Presentation of Financial Statements
for Various Not-for-Profit
and Governmental Organizations

M85#58. The comprehensive annual financial report
(CAFR) of a governmental unit should contain a com-
bined balance sheet for

<table>
<thead>
<tr>
<th>Governmental funds</th>
<th>Proprietary funds</th>
<th>Account groups</th>
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</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
Selected Questions

**M84#58.** Which of the following would be included in the Combined Statement of Revenues, Expenditures, and Changes in Fund Balances — Budget and Actual in the comprehensive annual financial report (CAFR) of a governmental unit?

<table>
<thead>
<tr>
<th>Enterprise fund</th>
<th>General fixed asset account group</th>
</tr>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**M83#58.** The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of changes in financial position for

<table>
<thead>
<tr>
<th>Governmental funds</th>
<th>Proprietary funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
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<tr>
<td>b. No</td>
<td>Yes</td>
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<tr>
<td>c. Yes</td>
<td>No</td>
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<tr>
<td>d. Yes</td>
<td>Yes</td>
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</tbody>
</table>

**E. Various Types of Not-for-Profit and Governmental Organizations**

**M85#59.** Which of the following should be included in the current funds revenues of a not-for-profit private university?

<table>
<thead>
<tr>
<th>Tuition waivers</th>
<th>Unrestricted bequests</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**M85#60.** Revenue from the gift shop of a hospital would normally be included in

a. Other nonoperating revenue.
b. Other operating revenue.
c. Patient service revenue.
d. Professional services revenue.

**M84#59.** Which of the following would be included in the unrestricted funds of a not-for-profit hospital?

a. Permanent endowments.
b. Term endowments.
c. Board designated funds originating from previously accumulated income.
d. Plant expansion and replacement funds.

**M84#60.** Which basis of accounting should a voluntary health and welfare organization use?

a. Cash basis for all funds.
b. Modified accrual basis for all funds.
c. Accrual basis for all funds.
d. Accrual basis for some funds and modified accrual basis for other funds.

**N83#59.** The current funds group of a not-for-profit private university includes which of the following subgroups?

<table>
<thead>
<tr>
<th>Term endowment funds</th>
<th>Life income funds</th>
</tr>
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<tbody>
<tr>
<td>a. No</td>
<td>No</td>
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<td>b. No</td>
<td>Yes</td>
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<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**N83#60.** Which of the following would normally be included in Other Operating Revenues of a voluntary not-for-profit hospital?

a. Unrestricted interest income from an endowment fund.
b. An unrestricted gift.
c. Donated services.
d. Tuition received from an educational program.

**M83#59.** Revenues of a municipality should be recognized in the accounting period in which they become available and measurable for a

<table>
<thead>
<tr>
<th>Governmental fund</th>
<th>Proprietary fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**M83#60.** Tuition waivers for which there is no intention of collection from the student should be classified by a not-for-profit university as

<table>
<thead>
<tr>
<th>Revenue</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
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<td>b. No</td>
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<tr>
<td>c. Yes</td>
<td>Yes</td>
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<tr>
<td>d. Yes</td>
<td>No</td>
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</table>

**N82#59.** A state governmental unit should use which basis of accounting for each of the following types of funds?

<table>
<thead>
<tr>
<th>Governmental</th>
<th>Proprietary</th>
</tr>
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<tbody>
<tr>
<td>a. Cash</td>
<td>Modified accrual</td>
</tr>
<tr>
<td>b. Modified accrual</td>
<td>Modified accrual</td>
</tr>
<tr>
<td>c. Modified accrual</td>
<td>Accrual</td>
</tr>
<tr>
<td>d. Accrual</td>
<td>Accrual</td>
</tr>
</tbody>
</table>

**N82#60.** An unrestricted pledge from an annual contributor to a voluntary not-for-profit hospital made in December 1981 and paid in cash in March 1982 would generally be credited to

c. Operating revenue in 1981.
d. Operating revenue in 1982.
M82#59. Which of the following is utilized for current expenditures by a not-for-profit university?

<table>
<thead>
<tr>
<th>Unrestricted current funds</th>
<th>Restricted current funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
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<td>Yes</td>
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<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

c. Fund balance.
d. Deferred revenue.

M81#59. For state and local governmental units, the full accrual basis of accounting should be used for what type of fund?

a. Special revenue.
b. General.
c. Debt service.
d. Internal service (intragovernmental service).

M82#60. Donated medicines which normally would be purchased by a hospital should be recorded at fair market value and should be credited directly to

a. Other operating revenue.
b. Other nonoperating revenue.

M81#60. A gift to a voluntary not-for-profit hospital that is not restricted by the donor should be credited directly to

a. Fund balance.
b. Deferred revenue.
c. Operating revenue.
d. Nonoperating revenue.
### SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

#### I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

<table>
<thead>
<tr>
<th>B. Conceptual Framework</th>
<th>M82#14 a</th>
<th>N81# 1 a</th>
<th>F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts</th>
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<tr>
<td>C. Basic Concepts and Accounting Principles</td>
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</table>

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

<table>
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<th>A. Cash, Marketable Securities, and Investments</th>
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<td>B. Receivables and Accruals</td>
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<td></td>
<td>N83#11 a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>N82# 6 c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>N84# 11 a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>M83# 10 c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>M83# 15 b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>M83#16 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>N82 # 8 d</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>N81 #11 b</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>D. Property, Plant, and Equipment Owned or Leased</th>
<th>N82# 10 c</th>
<th>N82# 12 c</th>
<th>N81# 12 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>M85# 9 b</td>
<td>M85#10 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M85#11 d</td>
<td>N84# 13 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 14 d</td>
<td>M85# 12 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 15 d</td>
<td>N84# 18 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 16 a</td>
<td>N84# 19 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 17 c</td>
<td>M84# 14 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 9 b</td>
<td>M84# 15 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M83# 12 c</td>
<td>M83# 17 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M83# 13 d</td>
<td>M83# 18 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M83# 14 d</td>
<td>M83# 19 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M82# 3 d</td>
<td>M82# 7 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M83# 10 c</td>
<td>M83# 15 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N81# 15 a</td>
<td>N81# 17 a</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>E. Intangibles and Other Assets</th>
<th>N83# 12 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>M83# 17 a</td>
<td>M83# 18 c</td>
</tr>
<tr>
<td>M83# 19 a</td>
<td>M83# 19 d</td>
</tr>
<tr>
<td>M82# 3 d</td>
<td>M83# 7 c</td>
</tr>
<tr>
<td>M83# 15 b</td>
<td>M82# 3 d</td>
</tr>
<tr>
<td>N81# 15 a</td>
<td>N81# 17 a</td>
</tr>
</tbody>
</table>

T-47
III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals
   - M85#14 b
   - M85#15 a
   - N84# 20 a
   - N84# 21 a
   - M84#16 d
   - M84#17 d
   - N83#13 a
   - M83#21 b
   - N81# 8 c

C. Deferred Income Tax Liabilities
   - M84#20 b
   - M84#21 c
   - M83#20 c
   - N83#14 d
   - N83#15 d
   - N83#16 d
   - M83#22 b
   - M82# 4 b
   - N83#17 b
   - N83#18 b
   - N82# 11 d
   - N82# 12 b
   - N82# 13 b
   - N81# 14 a
   - N81# 15 a
   - N81# 16 b

E. Bonds Payable
   - N84#23 a
   - M84#24 c
   - N84#25 a
   - N84#26 a
   - M85#16 c
   - M85#19 c
   - N83#16 d
   - N83#18 b
   - N82# 11 d
   - N82# 12 b
   - N82# 13 b
   - N81# 14 a
   - N81# 15 a
   - N81# 16 b

F. Contingent Liabilities and Commitments

D. Capitalized Lease Liability
   - N84#22 c
   - M84#18 a
   - M83#30 a
   - M82# 6 b
   - N82# 5 d
   - N81# 14 a
   - N81# 15 a
   - N81# 16 b
   - N81# 17 a
   - N81# 18 b
   - N82# 11 d

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock
   - M85#19 c
   - N81# 19 c
   - M81# 1 a

C. Retained Earnings and Dividends
   - M85#17 b
   - N84#28 d
   - M84#22 a
   - M84#23 b
   - N83#20 a
   - N83#21 a
   - N83#13 a
   - N81#24 b
   - M81#13 c

D. Treasury Stock and Other Contra Accounts
   - M85#18 a
   - N84#29 d
   - M84#25 b
   - N83#22 b
   - M83#27 c
   - N82#19 b
   - M82#13 b
   - M82#11 c
   - N81#22 c
   - M81# 9 b

E. Stock Options, Warrants, and Rights
   - M85#13 a
   - N84#30 a
   - M84#24 c
   - M83#23 b
   - N81#23 b
   - M81# 9 b
   - M85#20 a
   - M84#26 a

B. Additional Paid-in Capital
   - N84#27 a
   - N83#19 d
   - N82# 9 b
   - M81#12 a

G. Partnerships

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
   - M83#29 c
   - M82#21 b
   - M84#28 c
   - M82#22 b
   - N82#17 c
   - N83#26 a
   - N83#27 d
   - M82#23 a
   - M85#21 c
   - N81#29 a
   - M83#31 c
   - M82#31 a
   - M85#22 a
   - N81#34 b
   - M83#32 c
   - M82#34 d
   - N84#32 c
   - M83#33 b
   - N81#21 b
   - M83#34 a
   - N81#25 a
   - M84#34 c
   - N82#20 d
   - N81#26 d

B. Expenses and Losses
   - N83#24 a
   - M82#21 b
   - M81#17 d
   - N83#25 c
   - N84#34 d
   - M81#19 b
   - M83#26 b
   - N84#35 d
   - M81#20 b
   - M83#28 d
   - M84#27 b
   - M81#21 a

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Unofficial Answers

C. Provision for Income Tax
   M82#29 d
   M83#35 b
   N81#28 a
   N81#35 b

D. Recurring Versus Nonrecurring Transactions and Events
   M85#24 a
   N83#28 c
   N83#29 c
   M82#29 d
   N81#30 d
   M81#22 a

E. Accounting Changes
   M83#36 c
   M82#25 b
   M81#23 c

F. Earnings Per Share
   M85#25 d
   N84#37 a
   M84#29 d
   N81#31 a
   N81#32 a
   M81#24 c
   M81#25 a

VI. Other Financial Topics

A. Statement of Changes in Financial Position
   M85#26 d
   M85#27 c
   N84#38 a
   N84#39 a
   M84#30 b
   M84#31 b
   N83#30 a
   N83#31 d
   N83#38 a
   N82#27 a
   M82#27 c
   N81#33 c
   M81#26 c
   M81#27 d

B. Accounting Policies
   M85#29 c
   N84#41 a
   N83#33 a
   M83#34 d
   M81#28 c

C. Accounting Changes
   M85#28 c
   N84#40 b
   M84#32 b
   N83#32 b
   M83#40 d
   M82#28 a
   M82#24 c
   M81#29 d
   M82#17 a
   M81#30 d
   M81#31 d

D. Nonmonetary Transactions
   M82#30 d

E. Business Combinations
   M85#30 d

F. Interim Financial Statements
   M83#42 b
   N82#39 a
   M82#35 b
   N81#37 a
   M81#38 b

G. Gain Contingencies
   M85#35 c
   N84#45 d
   M84#35 c
   N83#45 c

H. Segments and Lines of Business
   M85#34 d
   N81#39 a
   M81#40 c

I. Employee Benefits
   M85#34 d
   N84#44 d
   N82#39 b
   M81#36 b

J. Analysis of Financial Statements
   M85#33 b

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements
   M83#46 c
   M82#42 b
   N81#41 d
   N81#42 b
   N83#39 b
   N83#41 d
   N82#41 d
   N82#43 a
   M84#43 b
   M82#42 d
   N83#42 b
   N81#43 a
   N81#44 c
   M81#44 a
   N81#45 d
   M83#48 d
   M82#48 a
   N82#50 b
   N84#50 b
   N84#51 b
   M84#43 b
   M84#44 a
   M85#39 a
   M85#40 a
   N84#50 b
   N84#51 b

B. Process and Job Order Costing
   M83#38 c
   M85#38 c
   M81#44 a
   N83#36 d
   N83#37 a
   M85#41 a
   N83#38 c
   N84#49 b
   N84#49 b

C. Standard Costing
   M85#39 a
   M85#40 a
   N84#50 b
   N84#51 b
   M84#43 b
   M84#44 a
   M85#39 a
   M85#40 a
   N84#50 b
   N84#51 b
   M84#43 b
   M84#44 a

T-49
Accounting Theory

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
   M85#50 d
   M84#45 a
   N82#44 c
   N82#45 b
   M82#44 a
   N81#48 b
   N81#49 d
   N81#57 b
   M81#48 d
   M81#49 c
   M85#42 c
   N84#53 c

F. Budgeting and Flexible Budgeting
   M85#50 d
   M84#52 d
   M84#45 a
   N82#44 c
   N82#45 b
   M82#44 a
   N81#48 b
   N81#49 d
   N81#57 b
   M81#48 d
   M81#49 c
   M85#44 a
   N84#55 d

G. Breakeven and Cost-Volume-Profit Analysis
   M85#51

H. Capital Budgeting Techniques

I. Performance Analysis
   M85#47 c
   N81#50 b
   N84#60 b
   N83#49 c

J. Other
   M85#48 d
   M85#49 a
   M84#49 d
   N83#50 b
   M83#50 b
   N82#47 d
   M84#41 c
   N83#48 b
   N81#54 a
   N81#58 d

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework
   M82#55 a
   N83#57 c
   M81#51 c
   M83#54 a
   M81#52 b
   M83#55 b
   M81#53 b
   M83#56 b
   M81#57 a
   M83#58 a
   M83#52 d
   M83#59 c
   M83#57 b
   M82#51 c
   M82#52 d
   M82#56 a
   M82#57 b

B. Fund Accounting
   M85#52 a
   M85#53 b
   M84#51 a
   M84#52 a
   M84#53 a
   M85#54 a
   N83#51 d
   M85#55 a
   N83#52 b
   M85#56 d
   N83#53 c
   M85#57 b
   M83#51 c
   M84#54 b
   M83#52 d
   M84#55 c
   M83#53 b
   M84#56 a
   N82#51 d
   M84#57 a
   N82#53 a
   N83#54 b
   M82#53 b
   N83#56 d

C. Types of Funds and Fund Accounts
   N82#54 b
   N82#55 a
   N82#56 b
   N82#57 b
   N82#58 d
   M82#58 a
   M81#54 d
   M81#56 b
   M81#57 a
   M81#58 d
   M83#59 a
   N83#59 a
   N83#60 d
   M83#59 a
   M83#60 c
   N82#59 c
   N82#60 c
   M82#59 d
   M82#60 a
   M81#59 d
   M81#60 d

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
   M85#58 b
   M84#58 d
   N83#58 b
   M85#59 b
   M85#60 b
   M84#59 c
   M84#60 c
   N83#59 a
   N83#60 d
   M83#59 a
   M83#60 c
   N82#59 c
   N82#60 c
   M82#59 d
   M82#60 a
   M81#59 d
   M81#60 d
ESSAYS — SELECTED QUESTIONS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

M84
Number 4 (Estimated time — 15 to 25 minutes)

Selected information from the balance sheets of Golden Company and Bridge Company at December 31, 1982, follows:

<table>
<thead>
<tr>
<th></th>
<th>Golden Company</th>
<th>Bridge Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td>(000 omitted)</td>
<td></td>
</tr>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$103,500</td>
<td>$ 800</td>
</tr>
<tr>
<td>Marketable equity securities, at cost which approximates market</td>
<td>13,000</td>
<td>—</td>
</tr>
<tr>
<td>Accounts receivable, net of allowance for doubtful accounts</td>
<td>55,000</td>
<td>24,700</td>
</tr>
<tr>
<td>Inventories, at lower of cost or market</td>
<td>76,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>2,500</td>
<td>500</td>
</tr>
<tr>
<td>Total current assets</td>
<td>250,000</td>
<td>51,000</td>
</tr>
<tr>
<td>Property, plant, and equipment, net of accumulated depreciation</td>
<td>311,000</td>
<td>62,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>29,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$590,000</td>
<td>$119,000</td>
</tr>
</tbody>
</table>

| Liabilities:       |                |                |
| Total liabilities (condensed) | $327,000 | $ 65,000 |

| Stockholders’ equity: |                |                |
| Common stock, par value $1.00 per share | 10,000 | 2,000 |
| Additional paid-in capital | 111,000 | 23,000 |
| Retained earnings | 142,000 | 29,000 |
| Total stockholders’ equity | 263,000 | 54,000 |
| Total liabilities and stockholders’ equity | $590,000 | $119,000 |

Additional facts are as follows:

- On January 1, 1983, Golden acquired for cash of $101,000,000 all of the shares of outstanding stock of Bridge. The market (fair) values of Bridge’s assets and liabilities on January 1, 1983, were the same as the book values on December 31, 1982, except property, plant and equipment, net of accumulated depreciation, which had a market value of $93,000,000 on January 1, 1983. Golden and Bridge are in similar lines of business.

- Dividends of $400,000 were received during 1983 from the marketable equity securities held by Golden. All of these securities were accounted for by the cost method. Bridge did not pay any dividends to Golden in 1983.

- $10,000,000 of the marketable equity securities held by Golden on December 31, 1982 were sold during 1983 for $10,200,000. No marketable equity securities were purchased in 1983. On December 31, 1983, the remaining marketable equity securities portfolio held by Golden had a cost of $3,000,000 and a market value of $2,500,000.
Required:

a. Should consolidated financial statements for Golden and Bridge be presented for 1983? Explain why or why not.

b. If consolidated financial statements were prepared for the year ended December 31, 1983, how should the excess of the cash paid by Golden over the book value of Bridge be accounted for in those consolidated financial statements? Why? Ignore income tax considerations.

c. How should the marketable equity securities transactions and situation described in the additional facts above be accounted for? Why?

N83
Number 4 (Estimated time — — 15 to 25 minutes)

Selected information from the financial statements of the Pace Company follows:

**Pace Company**

CURRENT ASSETS SECTION OF
BALANCE SHEETS

<table>
<thead>
<tr>
<th></th>
<th>December 31, 1982</th>
<th>December 31, 1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 7,000</td>
<td>$ 7,200</td>
</tr>
<tr>
<td>Marketable securities, at cost which approximates market</td>
<td>26,000</td>
<td>22,000</td>
</tr>
<tr>
<td>Accounts receivable, net of allowance for doubtful accounts</td>
<td>210,000</td>
<td>190,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>252,000</td>
<td>308,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>5,000</td>
<td>4,800</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$500,000</td>
<td>$532,000</td>
</tr>
</tbody>
</table>

**Pace Company**

STATEMENTS OF INCOME

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31, 1982</th>
<th>Year ended December 31, 1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,200,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Costs and expenses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>960,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Selling, general and administrative expenses</td>
<td>147,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Other, net</td>
<td>24,000</td>
<td>18,300</td>
</tr>
<tr>
<td>Total costs and expenses</td>
<td>$1,131,000</td>
<td>$938,300</td>
</tr>
<tr>
<td>Income from continuing operations before income taxes</td>
<td>69,000</td>
<td>61,700</td>
</tr>
<tr>
<td>Income taxes</td>
<td>26,900</td>
<td>25,300</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>42,100</td>
<td>36,400</td>
</tr>
<tr>
<td>Cumulative effect of change in estimates of salvage values of property, plant, and equipment, less applicable income taxes of $1,500,000</td>
<td>—</td>
<td>3,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$42,100</td>
<td>$33,400</td>
</tr>
<tr>
<td>Earnings per share of common stock:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>$4.21</td>
<td>$3.64</td>
</tr>
<tr>
<td>Cumulative effect of change in estimates of salvage values of property, plant, and equipment, less applicable income taxes</td>
<td>—</td>
<td>.30</td>
</tr>
<tr>
<td>Net income</td>
<td>$4.21</td>
<td>$3.34</td>
</tr>
</tbody>
</table>
Selected information from the notes to the financial statements of the Pace Company is as follows:

[From Summary of Significant Accounting Policies]

Inventories — Inventories are stated at the lower of cost (first-in, first-out) or market.

Deferred Income Taxes — Deferred income taxes arise from timing differences when profits or expenses are included in taxable income on the income tax return later or earlier than they are included in the statement of income. Such timing differences principally relate to depreciation.

A provision for deferred income taxes of $6,700,000 in 1982 and $6,300,000 in 1981 is included in the statements of income in “Other, net.”

[From Notes to Financial Statements]

Inventories — Inventories are comprised of the following:

<table>
<thead>
<tr>
<th></th>
<th>December 31, 1982</th>
<th>December 31, 1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finished goods</td>
<td>$176,000</td>
<td>$215,000</td>
</tr>
<tr>
<td>Goods in process</td>
<td>13,000</td>
<td>14,000</td>
</tr>
<tr>
<td>Raw materials</td>
<td>63,000</td>
<td>79,000</td>
</tr>
<tr>
<td></td>
<td>$252,000</td>
<td>$308,000</td>
</tr>
</tbody>
</table>

Inventories at December 31, 1982, were reduced from a cost of $292,000,000 to a market value of $252,000,000 using the direct inventory reduction method. The cost of inventories at December 31, 1981, approximated their market value.

Accounting Change — During the third quarter of 1981, Pace Company revised earlier estimates of salvage values for its property, plant, and equipment. This change in accounting reduced the 1981 net income by $3,000,000 ($0.30 per share).

Required:

a. Are inventories and the related cost of goods sold presented appropriately? Explain why or why not. If the presentation is not appropriate, specify the appropriate presentation and explain why.

b. 1. What are the components of the quick (acid-test) ratio?
   2. How should the quick (acid-test) ratio be used?

c. Is the provision for deferred income taxes presented appropriately? Explain why or why not. If the presentation is not appropriate, specify the appropriate presentation and explain why.

d. Is the accounting change presented appropriately? Explain why or why not. If the presentation is not appropriate, specify the appropriate presentation and explain why. Assume that the accounting change did not involve deferred income taxes.

N81
Number 4

Part a. The Whit Company and the Berry Company, a manufacturer and retailer, respectively, entered into a business combination whereby the Whit Company acquired for cash all of the outstanding voting common stock of the Berry Company.

Required:

1. The Whit Company is preparing consolidated financial statements immediately after the consummation of the above-stated business combination. How should the Whit Company determine in general the amounts to be reported for the assets and liabilities of Berry Company? Assuming that the business combination resulted in goodwill, indicate how the amount of goodwill is determined.

2. Why and under what circumstances should Berry Company be included in the entity’s consolidated financial statements?

N81
Number 3 (Estimated time — 15 to 25 minutes)

Financial reporting should provide information to help investors, creditors, and other users of financial statements. Statement of Financial Accounting Standards No. 33 requires large public enterprises to disclose certain supplementary information.

Required:

a. Describe the historical cost/constant dollar method of accounting. Include in your discussion how historical cost amounts are used to make historical cost/constant dollar measurements.

b. Describe the principal advantage of the historical cost/constant dollar method of accounting over the historical cost method of accounting.

c. Describe the current cost method of accounting.

d. Why would depreciation expense for a given year differ using the current cost method of accounting instead of the historical cost method of accounting? Include in your discussion whether depreciation expense is likely to be higher or lower using the current cost method of accounting instead of the historical cost method of accounting in a period of rising prices, and why.
II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

M85
Number 3 (Estimated time — — 15 to 25 minutes)

On July 1, 1984, Marie Company sold special-order merchandise on credit and received in return an interest-bearing note receivable from the customer. Marie will receive interest at the prevailing rate for a note of this type. Both the principal and interest are due in one lump sum on June 30, 1985.

On September 1, 1984, Marie sold special-order merchandise on credit and received in return a non-interest-bearing note receivable from the customer. The prevailing rate of interest for a note of this type is determinable. The note receivable is due in one lump sum on August 31, 1986.

Marie also has significant amounts of trade accounts receivable as a result of credit sales to its customers. On October 1, 1984, some trade accounts receivable were assigned to Daniel Finance Company on a with recourse, nonnotification basis for an advance of 75% of their amount at an interest charge of 20% on the balance outstanding.

On November 1, 1984, other trade accounts receivable were factored on a without recourse basis. The factor withheld 5% of the trade accounts receivable factored as protection against sales returns and allowances and charged a finance charge of 3%.

Required:

a. How should Marie determine the interest income for 1984 on the
   1. interest-bearing note receivable? Why?
   2. noninterest-bearing note receivable? Why?

b. How should Marie report the interest-bearing note receivable and the noninterest-bearing note receivable on its balance sheet at December 31, 1984?

c. How should Marie account for subsequent collections on the trade accounts receivable assigned on October 1, 1984, and the payments to Daniel Finance? Why?

d. How should Marie account for the trade accounts receivable factored on November 1, 1984? Why?

M84
Number 2 (Estimated time — — 15 to 25 minutes)

Diane Company, a retailer and wholesaler of national brand name household lighting fixtures, purchases its inventories from various suppliers.

Required:

a. 1. What criteria should be used to determine which of Diane's costs are inventoriable?

b. 1. Diane uses the lower of cost or market rule for its wholesale inventories. What are the theoretical arguments for that rule?
   2. The replacement cost of the inventories is below the net realizable value less a normal profit margin, which, in turn, is below the original cost. What amount should be used to value the inventories? Why?

   c. Diane calculates the estimated cost of its ending inventories held for sale at retail using the conventional (lower of average cost or market) retail inventory method. How would Diane treat the beginning inventories, and net markdowns in calculating the cost ratio used to determine its ending inventories? Why?

N83
Number 2 (Estimated time — — 15 to 25 minutes)

George Company purchased land for use as its corporate headquarters. A small factory that was on the land when it was purchased was torn down before construction of the office building began. Furthermore, a substantial amount of rock blasting and removal had to be done to the site before construction of the building foundation began. Because the office building was set back on the land far from the public road, George Company had the contractor construct a paved road which led from the public road to the parking lot of the office building.
Three years after the office building was occupied, George Company added four stories to the office building. The four stories had an estimated useful life of five years more than the remaining estimated useful life of the original office building.

Ten years later the land and building were sold at an amount more than their net book value and George Company had a new office building constructed in another state for use as its new corporate headquarters.

Required:

a. Which of the above expenditures should be capitalized? How should each be depreciated or amortized? Discuss the rationale for your answers.

b. How would the sale of the land and building be accounted for? Include in your answer how to determine the net book value at the date of sale. Discuss the rationale for your answer.

M63
Number 2 (Estimated time — 15 to 25 minutes)

Taylor Company, a household appliances dealer, purchases its inventories from various suppliers. Taylor has consistently stated its inventories at the lower of cost (FIFO) or market.

Required:

a. Taylor is considering alternate methods of accounting for the cash discounts it takes when paying its suppliers promptly. From a theoretical standpoint, discuss the acceptability of each of the following methods:

1. Financial income when payments are made.
2. Reduction of cost of goods sold for period when payments are made.
3. Direct reduction of purchase cost.

b. Identify the effects on both the balance sheet and the income statement of using the LIFO inventory method instead of the FIFO method over a substantial time period when purchase prices of household appliances are rising. State why these effects take place.

c. Why is the lower of cost-or-market rule used for valuing inventories when the FIFO method is used?

N82
Number 2 (Estimated time — 15 to 25 minutes)

Part a. On July 1, 1981, Carme Company, a calendar-year company, sold special-order merchandise on credit and received in return an interest-bearing note receivable from the customer. Carme Company will receive interest at the prevailing rate for a note of this type. Both the principal and interest are due in one lump sum on June 30, 1982.

Required:

1. When should Carme Company report interest income from the note receivable? Discuss the rationale for your answer.

2. Assume that the note receivable was discounted without recourse at a bank on December 31, 1981. How would Carme Company determine the amount of the discount and what is the appropriate accounting for the discounting transaction?

Part b. On December 31, 1981, Carme Company had significant amounts of accounts receivable as a result of credit sales to its customers. Carme Company uses the allowance method based on credit sales to estimate bad debts. Based on past experience, 1% of credit sales normally will not be collected. This pattern is expected to continue.

Required:

1. Discuss the rationale for using the allowance method based on credit sales to estimate bad debts. Contrast this method with the allowance method based on the balance in the trade receivables accounts.

2. How should Carme Company report the allowance for bad debts account on its balance sheet at December 31, 1981? Also, describe the alternatives, if any, for presentation of bad debt expense in Carme Company’s 1981 income statement.

M82
Number 2 (Estimated time — 15 to 25 minutes)

Part a. At the end of its first year of operations, Key Company had a current marketable equity securities portfolio with a cost of $500,000 and a market value of $550,000. At the end of its second year of operations, Key Company had a current marketable equity securities portfolio with a cost of $525,000 and a market value of $475,000. No securities were sold during the first year. One security with a cost of $80,000 and a market value of $70,000 at the end of the first year was sold for $100,000 during the second year.

Required:

How should Key Company report the above facts in its balance sheets and income statements for both years? Discuss the rationale for your answer.

Part b. On July 1, 1981, Dynamic Company purchased for cash 40 percent of the outstanding capital stock of Cart Company. Both Dynamic Company and Cart Company have a December 31 year end. Cart Company, whose common stock is actively traded in the over-the-counter market, reported its total net income for the year to Dynamic Company, and also paid cash dividends on November 15, 1981, to Dynamic Company and its other stockholders.

Required:

How should Dynamic Company report the above facts in its December 31, 1981, balance sheet and its income statement for the year then ended? Discuss the rationale for your answer.
Accounting Theory

M81
Number 5 (Estimated time — 15 to 25 minutes)

Doherty Company leased equipment from Lambert Company. The classification of the lease makes a difference in the amounts reflected on the balance sheet and income statement of both Doherty Company and Lambert Company.

Required:

a. What criteria must be met by the lease in order that Doherty Company classify it as a capital lease?

b. What criteria must be met by the lease in order that Lambert Company classify it as a sales-type or direct financing lease?

c. Contrast a sales-type lease with a direct financing lease.

M81
Number 4 (Estimated time — 15 to 25 minutes)

Retail, Inc., sells normal brand name household products both from its own store and on consignment through The Mall Space Company.

Required:

a. Should Retail, Inc., include in its inventory normal brand name goods purchased from its suppliers but not yet received if the terms of purchase are FOB shipping point (manufacturer's plant)? Why?

b. Should Retail, Inc., include freight-in expenditures as an inventoriable cost? Why?

c. Retail, Inc., purchased cooking utensils for sale in the ordinary course of business three times during the current year, each time at a higher price than the previous purchase. What would have been the effect on ending inventory and cost of goods sold had Retail, Inc., used the weighted-average cost method instead of the FIFO method?

d. How and why will Retail, Inc., treat net markdowns when it calculates the estimated cost of ending inventory using the conventional (lower of cost or market) retail inventory method?

e. What are products on consignment and how should they be presented on the balance sheets of Retail, Inc., and The Mall Space Company?

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

M85
Number 2 (Estimated time — 15 to 25 minutes)

On January 1, 1984, Lani Company entered into a noncancelable lease for a machine to be used in its manufacturing operations. The lease transfers ownership of the machine to Lani by the end of the lease term. The term of the lease is eight years. The minimum lease payment made by Lani on January 1, 1984, was one of eight equal annual payments. At the inception of the lease, the criteria established for classification as a capital lease by the lessee were met.

Required:

a. What is the theoretical basis for the accounting standard which requires certain long-term leases to be capitalized by the lessee? Do not discuss the specific criteria for classifying a specific lease as a capital lease.

b. How should Lani account for this lease at its inception and determine the amount to be recorded?

c. What expenses related to this lease will Lani incur during the first year of the lease, and how will they be determined?

d. How should Lani report the lease transaction on its December 31, 1984, balance sheet?

M85
Number 4 (Estimated time — 15 to 25 minutes)

On October 1, 1984, Janine Company sold some of its 5-year, $1,000 face value, 12% term bonds dated March 1, 1984 at an effective annual interest rate (yield) of 10%. Interest is payable semiannually and the first interest payment date is September 1, 1984. Janine uses the interest method of amortization. Bond issue costs were incurred in preparing and selling the bond issue.

On November 1, 1984, Janine sold directly to underwriters at a lump-sum price, $1,000 face value, 9% serial bonds dated November 1, 1984 at an effective annual interest rate (yield) of 11%. A total of 25% of these serial bonds are due on November 1, 1986, a total of 35% on November 1, 1987, and a total of 40% on November 1, 1988. Interest is payable semiannually and the first interest payment date is May 1, 1985. Janine uses the interest method of amortization. Bond issue costs were incurred in preparing and selling the bond issue.

Required:

a. How would the market price of the term bonds and the serial bonds be determined?
Selected Questions

b. 1. How would all items related to the term bonds, except for bond issue costs, be presented in a balance sheet prepared immediately after the term bond issue was sold?

2. How would all items related to the serial bonds, except for bond issue costs, be presented in a balance sheet prepared immediately after the serial bond issue was sold?

c. What alternative methods could be used to account for the bond issue costs for the term bonds in 1984?

d. How would the amount of interest expense for the term bonds and the serial bonds be determined for 1984?

N84
Number 2 (Estimated time — 15 to 25 minutes)

Angela Company is a manufacturer of toys. During the year, the following situations arose:

• A safety hazard related to one of its toy products was discovered. It is considered probable that liabilities have been incurred. Based on past experience, a reasonable estimate of the amount of loss can be made.

• One of its small warehouses is located on the bank of a river and could no longer be insured against flood losses. No flood losses have occurred after the date that the insurance became unavailable.

• This year, Angela began promoting a new toy by including a coupon, redeemable for a movie ticket, in each toy’s carton. The movie ticket, which cost Angela $2, is purchased in advance and then mailed to the customer when the coupon is received by Angela. Angela estimated, based on past experience, that sixty percent of the coupons would be redeemed. Forty percent of the coupons were actually redeemed this year, and the remaining twenty percent of the coupons are expected to be redeemed next year.

Required:

a. How should Angela report the safety hazard? Why? Do not discuss deferred income tax implications.

b. How should Angela report the noninsurable flood risk? Why?

c. How should Angela account for the toy promotion campaign in this year?

N83
Number 5 (Estimated time — 15 to 25 minutes)

On January 1, Borman Company, a lessee, entered into three noncancelable leases for brand-new equipment, Lease J, Lease K, and Lease L. None of the three leases transfers ownership of the equipment to Borman at the end of the lease term. For each of the three leases, the present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, is 75% of the excess of the fair value of the equipment to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by the lessor.

The following information is peculiar to each lease:

• Lease J does not contain a bargain purchase option; the lease term is equal to 80% of the estimated economic life of the equipment.

• Lease K contains a bargain purchase option; the lease term is equal to 50% of the estimated economic life of the equipment.

• Lease L does not contain a bargain purchase option; the lease term is equal to 50% of the estimated economic life of the equipment.

Required:

a. How should Borman Company classify each of the three leases above, and why? Discuss the rationale for your answer.
b. What amount, if any, should Borman record as a liability at the inception of the lease for each of the three leases above?

c. Assuming that the minimum lease payments are made on a straight-line basis, how should Borman record each minimum lease payment for each of the three leases above?

M83
Number 5 (Estimated time — 15 to 25 minutes)

Part a. Reece Company sells two types of merchandise, Type A and Type B. Each carries a one-year warranty.

- Type A merchandise — Product warranty costs, based on past experience, will normally be 1% of sales.
- Type B merchandise — Product warranty costs cannot be reasonably estimated because this is a new product line. However, the chief engineer believes that product warranty costs are likely to be incurred.

Required:

How should Reece report the estimated product warranty costs for each of the two types of merchandise above? Discuss the rationale for your answer. Do not discuss deferred income tax implications, or disclosures that should be made in Reece's financial statements or notes.

Part b. Carpenter Company is being sued for $2,000,000 for an injury caused to a child as a result of alleged negligence while the child was visiting the Carpenter Company plant in March 1982. The suit was filed in July 1982. Carpenter's lawyer states that it is probable that Carpenter will lose the suit and be found liable for a judgment costing anywhere from $200,000 to $900,000. However, the lawyer states that the most probable judgment is $400,000.

Required:

How should Carpenter report the suit in its 1982 financial statements? Discuss the rationale for your answer. Include in your answer disclosures, if any, that should be made in Carpenter's financial statements or notes.

N82
Number 3 (Estimated time — 15 to 25 minutes)

On February 1, 1979, Aubrey Company sold its 5-year, $1,000 par value, 8% bonds, which were convertible at the option of the investor into Aubrey Company common stock at a ratio of 10 shares of common stock for each bond. The convertible bonds were sold by Aubrey Company at a discount. Interest is payable annually each February 1. On February 1, 1982, Mel Company, an investor in the Aubrey Company convertible bonds, tendered 1,000 bonds for conversion into 10,000 shares of Aubrey Company common stock, which had a market value of $110 per share at the date of the conversion.

On May 1, 1982, Aubrey Company sold its 10-year, $1,000 par value, 14% nonconvertible term bonds dated April 1, 1982. Interest is payable semiannually and the first interest payment date is October 1, 1982. Due to market conditions, the bonds were sold at an effective interest rate (yield) of 16%.

Required:

a. How should Aubrey Company account for the conversion of the convertible bonds into common stock under both the book value and market value methods? Discuss the rationale for each method.

b. Were the nonconvertible term bonds sold at par, at a discount, or at a premium? Discuss the rationale for your answer.

c. Identify and discuss the effects on Aubrey Company’s 1982 income statement associated with the nonconvertible term bonds.
IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

M83
Number 3 (Estimated time — — 15 to 25 minutes)

Lynch Company's Statement of Stockholders' Equity and Statement of Retained Earnings at December 31, 1982, and December 31, 1981 are presented below:

**Lynch Company**

**STATEMENT OF STOCKHOLDERS' EQUITY**

<table>
<thead>
<tr>
<th></th>
<th>December 31, 1982</th>
<th>December 31, 1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, par value $1.00 per share; authorized 40,000,000 shares; issued 22,000,000 shares at December 31, 1982, and 20,000,000 shares at December 31, 1981</td>
<td>$22,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>240,000</td>
<td>222,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>296,000</td>
<td>280,000</td>
</tr>
<tr>
<td></td>
<td>$558,000</td>
<td>$522,000</td>
</tr>
</tbody>
</table>

**Lynch Company**

**STATEMENT OF RETAINED EARNINGS**

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31, 1982</th>
<th>December 31, 1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings at beginning of period, as previously reported</td>
<td>$280,000</td>
<td>$264,000</td>
</tr>
<tr>
<td>Adjustment for extraordinary item</td>
<td>14,000</td>
<td>—</td>
</tr>
<tr>
<td>Retained earnings at beginning of period, as restated</td>
<td>294,000</td>
<td>264,000</td>
</tr>
<tr>
<td>Net income</td>
<td>52,400</td>
<td>47,400</td>
</tr>
<tr>
<td>Adjustment for correction of error</td>
<td>—</td>
<td>(11,000)</td>
</tr>
<tr>
<td>Cash dividends</td>
<td>(24,400)</td>
<td>(20,400)</td>
</tr>
<tr>
<td>10% stock dividend</td>
<td>(20,000)</td>
<td>—</td>
</tr>
<tr>
<td>Treasury stock</td>
<td>(6,000)</td>
<td>—</td>
</tr>
<tr>
<td>Retained earnings at end of period</td>
<td>$296,000</td>
<td>$280,000</td>
</tr>
</tbody>
</table>

Additional facts are as follows:

- The extraordinary item of $14,000,000 is net of income taxes of $8,000,000.
- On July 16, 1982, Lynch Company purchased 500,000 shares of its own common stock for $12 per share. The cost method of accounting was used for this treasury stock transaction.

**Required:**

a. Determine whether the presentation of the following in the Lynch Company Statement of Retained Earnings is appropriate:

- Adjustment for extraordinary item.
- Adjustment for correction of error.
- 10% stock dividend.
- Treasury stock.

If the presentation is appropriate, explain why. If the presentation is not appropriate, specify the appropriate presentation and explain why.

Do not discuss disclosure requirements for the Notes to the Financial Statements.

b. How did the additional facts above concerning the stock dividend and treasury stock transaction affect the cash dividend per-share (pay-out) ratio?
V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M85
Number 5 (Estimated time — — 15 to 25 minutes)

The Primrose Company appropriately uses the deferred method for interperiod income tax allocation. Primrose reports depreciation expense for certain machinery purchased this year using the accelerated cost recovery system (ACRS) for income tax purposes and the straight-line basis for accounting purposes. The tax deduction is the larger amount this year. Primrose received rent revenues in advance this year. These revenues are included in this year’s taxable income. However, for accounting purposes, these revenues are reported as unearned revenues, a current liability.

Required:

a. What is the theoretical basis for deferred income taxes?

b. How would Primrose determine and account for the income tax effect for the depreciation and rent? Why?

c. How should Primrose classify the income tax effect of the depreciation and rent on its balance sheet and income statement? Why?

M84
Number 5 (Estimated time — — 15 to 25 minutes)

Carol Company has many long-time employees who have built up substantial employee benefits. Among these employee benefits are a pension plan adopted six years ago, a compensatory stock option plan, and compensation for future vacations.

Required:

a. What are the major components of Carol’s annual provision for pension cost?

b. Specify how past service cost should be handled in calculating the minimum and maximum limits.

c. When should deferred compensation cost be recognized in the Carol income statement for a compensatory stock option plan for which the date of grant is 1. The same as the measurement date? Why? 2. Before the measurement date? Why?

d. What conditions must be met for Carol to accrue compensation for future vacations? Include in your answer the theoretical rationale for accruing compensation for future vacations.

N84
Number 4 (Estimated time — — 15 to 25 minutes)

Morgan Company grows various crops and then processes them for sale to retailers. Morgan has changed its depreciation method for its processing equipment from the double-declining balance method to the straight-line method effective January 1 of this year. This change has been determined to be preferable.

In the latter part of this year, Morgan had a large portion of its crops destroyed by a hailstorm. Morgan has incurred substantial costs in raising the crops destroyed by the hailstorm. Severe damage from hailstorms in the locality where the crops are grown is rare.

Required:

a. How should Morgan report and calculate the effect of this change in accounting principle relative to the depreciation method in this year’s income statement? Do not discuss earnings per share requirements.

b. Where should Morgan report the effects of the hailstorm in its income statement? Why?

c. How does the classification in the income statement of an extraordinary item differ from that of an operating item? Why? Do not discuss earnings per share requirements.

N83
Number 3 (Estimated time — — 15 to 25 minutes)

The Michael Company is accounting for a long-term construction contract using the percentage-of-completion method. It is a four-year contract that is presently in its second year. The latest estimates of total contract costs indicate that the contract will be completed at a profit to Michael Company.

Required:

a. What theoretical justification is there for Michael Company’s use of the percentage-of-completion method?

b. How would progress billings be accounted for? Include in your discussion the classification of progress billings in the Michael Company financial statements.

c. How would the income recognized in the second year of the four-year contract be determined using the cost-to-cost method of determining percentage of completion?

d. What would be the effect on earnings per share in the second year of the four-year contract of using the percentage-of-completion method instead of the completed-contract method? Discuss.
Selected Questions

N82
Number 5 (Estimated time — — 15 to 25 minutes)

David Company's Statements of Income for the year ended December 31, 1981, and December 31, 1980 are presented below:

David Company

STATMENTS OF INCOME

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31,</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1981</td>
<td>1980</td>
</tr>
<tr>
<td></td>
<td>(000 omitted)</td>
<td>(000 omitted)</td>
</tr>
<tr>
<td>Net sales</td>
<td>$900,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Costs and expenses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>720,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Selling, general, and administrative expenses</td>
<td>112,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Other, net</td>
<td>11,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Total costs and expenses</td>
<td>843,000</td>
<td>699,000</td>
</tr>
<tr>
<td>Income from continuing operations before income taxes</td>
<td>57,000</td>
<td>51,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>23,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>34,000</td>
<td>27,000</td>
</tr>
<tr>
<td>Loss on disposal of Dex Division, including provision of $1,500,000 for operating losses during phase-out period, less applicable income taxes of $8,000,000</td>
<td>8,000</td>
<td>—</td>
</tr>
<tr>
<td>Cumulative effect on prior years of change in depreciation method, less applicable income taxes of $1,500,000</td>
<td>—</td>
<td>3,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$26,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Earnings per share of common stock:

|                      |              |
| Income before cumulative effect of change in depreciation method | $2.60 | $2.70 |
| Cumulative effect on prior years of change in depreciation method, less applicable income taxes | — | .30 |
| Net income | $2.60 | $3.00 |

Additional facts are as follows:

- On January 1, 1980, David Company changed its depreciation method for previously recorded plant machinery from the double-declining-balance method to the straight-line method. The effect of applying the straight-line method for the year of and the year after the change is included in David Company's Statements of Income for the year ended December 31, 1981, and December 31, 1980, in "cost of goods sold."

- The loss from operations of the discontinued Dex Division from January 1, 1981, to September 30, 1981, (the portion of the year prior to the measurement date) and from January 1, 1980, to December 31, 1980, is included in David Company's Statements of Income for the year ended December 31, 1981, and December 31, 1980, respectively, in "Other, net."

- David Company has a simple capital structure with only common stock outstanding and the net income per share of common stock was based on the weighted-average number of common shares outstanding during each year.

- David Company common stock is listed on the New York Stock Exchange and closed at $13 per share on December 31, 1981, and $15 per share on December 31, 1980.

Required:

a. Determine from the additional facts above whether the presentation of those facts in David Company's Statements of Income is appropriate. If the presentation is appropriate, discuss the theoretical rationale for the presentation. If the presentation is not appropriate, specify the appropriate presentation and discuss its theoretical rationale.

b. Do not discuss disclosure requirements for the Notes to the Financial Statements.

b. Describe the general significance of the price-earnings ratio. Based on David Company's Statements of Income, and the additional facts above, describe how to determine the price-earnings ratio for 1981 only.
The Horizon Company is listed on the New York Stock Exchange. The market value of its common stock was quoted at $18 per share at both December 31, 1981, and December 31, 1980. Horizon’s Balance Sheets at December 31, 1981, and December 31, 1980, and Statements of Income and Retained Earnings for the years then ended are presented below:

**Horizon Company**

**BALANCE SHEETS**

<table>
<thead>
<tr>
<th>December 31,</th>
<th>1981</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>(000 omitted)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Assets:**

Current assets:
- Cash: $3,500, $3,600
- Marketable securities, at cost which approximates market: 13,000, 11,000
- Accounts receivable, net of allowance for doubtful accounts: 105,000, 95,000
- Inventories at lower of cost or market: 126,000, 154,000
- Prepaid expenses: 2,500, 2,400
- Total current assets: 250,000, 266,000

Property, plant, and equipment, net of accumulated depreciation: 311,000, 308,000

Other assets: 29,000, 34,000

Total assets: $590,000, $608,000

**Liabilities and Stockholders’ Equity:**

Current liabilities:
- Notes payable: $5,000, $15,000
- Accounts payable and accrued expenses: 62,500, 74,500
- Income taxes payable: 1,000, 1,000
- Payments due within one year on long-term debt: 6,500, 7,500
- Total current liabilities: 75,000, 98,000

Long-term debt: 169,000, 180,000

Deferred income taxes: 74,000, 67,000

Other liabilities: 9,000, 8,000

Stockholders’ equity:
- Common stock, par value $1.00 per share; authorized 20,000,000 shares; issued and outstanding: 10,000,000 shares
- Additional paid-in capital: 111,000, 111,000
- Retained earnings: 142,000, 134,000
- Total stockholders’ equity: 263,000, 255,000
- Total liabilities and stockholders’ equity: $590,000, $608,000
Horizon Company
STATEMENTS OF INCOME AND RETAINED EARNINGS

<table>
<thead>
<tr>
<th></th>
<th>1981</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$600,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Costs and expenses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>480,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Selling, general, and administrative expenses</td>
<td>66,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Other, net</td>
<td>17,000</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>Total costs and expenses</strong></td>
<td><strong>563,000</strong></td>
<td><strong>466,000</strong></td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>37,000</td>
<td>34,000</td>
</tr>
<tr>
<td>Income taxes</td>
<td>16,800</td>
<td>15,800</td>
</tr>
<tr>
<td>Net income</td>
<td>20,200</td>
<td>18,200</td>
</tr>
<tr>
<td>Retained earnings at beginning of period, as previously reported</td>
<td>141,000</td>
<td>132,000</td>
</tr>
<tr>
<td><strong>Adjustment required for correction of an error</strong></td>
<td><strong>(7,000)</strong></td>
<td><strong>(6,000)</strong></td>
</tr>
<tr>
<td>Retained earnings at beginning of period, as restated</td>
<td>134,000</td>
<td>126,000</td>
</tr>
<tr>
<td>Dividends on common stock</td>
<td>12,200</td>
<td>10,200</td>
</tr>
<tr>
<td><strong>Retained earnings at end of period</strong></td>
<td><strong>$142,000</strong></td>
<td><strong>$134,000</strong></td>
</tr>
</tbody>
</table>

Additional facts are as follows:

- "Selling, general and administrative expenses" for 1981 included a usual but infrequently occurring charge of $9,000,000.

- "Other, net" for 1981 included an extraordinary item (charge) of $10,000,000. If the extraordinary item (charge) had not occurred, income taxes for 1981 would have been $21,800,000 instead of $16,800,000.

- "Adjustment required for correction of an error" was a result of a change from an accounting principle that is not generally accepted to one that is generally accepted.

- Horizon Company has a simple capital structure and has disclosed earnings per common share for net income in the Notes to the Financial Statements.

Required:

a. Determine from the additional facts above whether or not the presentation of those facts in the above Horizon Company Statements of Income and Retained Earnings is appropriate. If the presentation is appropriate, discuss the theoretical rationale for the presentation. If the presentation is not appropriate, describe the appropriate presentation and discuss its theoretical rationale.

Do not discuss disclosure requirements for the Notes to the Financial Statements.

b. Describe the general significance of the following financial analysis tools:

- Quick (acid-test) ratio.
- Inventory turnover.
- Return on stockholders’ equity.

c. Based on the Horizon Company Balance Sheets, Statements of Income and Retained Earnings, and additional facts, describe how to determine each of the above financial analysis tools (for the year 1981 only).
Accounting Theory

M82
Number 4 (Estimated time — — 15 to 25 minutes)

Part a. This year Lorac Company has each of the following items in its income statement:
- Gross profits on installment sales.
- Revenues on long-term construction contracts.
- Estimated costs of product warranty contracts.
- Premiums on officers' life insurance with Lorac as beneficiary.

Required:
1. Under what conditions would deferred income taxes need to be reported in the financial statements?

2. Specify when deferred income taxes would need to be recognized for each of the items above, and indicate the rationale for such recognition.

Part b. Eneri Company's president has heard that deferred income taxes can be variously classified in the balance sheet.

Required:
Identify the conditions under which deferred income taxes would be classified as a noncurrent item in the balance sheet. What justification exists for such classification?

VI. Other Financial Topics

N81
Number 2 (Estimated time — — 15 to 25 minutes)

It is important in accounting theory to be able to distinguish the types of accounting changes.

Required:
a. If a public company desires to change from the sum-of-the-years'-digits depreciation method to the straight-line method for its fixed assets, what type of accounting change would this be? Discuss the permissibility of this change.

b. When pro forma disclosure is required for an accounting change, how are these pro forma amounts determined?

c. If a public company obtained additional information about the service lives of some of its fixed assets which showed that the service lives previously used should be shortened, what type of accounting change would this be? Include in your discussion how the change should be reported in the income statement of the year of the change, and what disclosures should be made in the financial statements or notes.

d. Changing specific subsidiaries comprising the group of companies for which consolidated financial statements are presented is an example of what type of accounting change, and what effect does it have on the consolidated income statements?

N81
Number 4

Part b. The Bert Company and the Lyle Company entered into a business combination accounted for as a pooling of interests.

Required:
1. How should the expenses related to effecting the business combination be handled, and why?

2. How should the results of operations for the year in which the business combination occurred be reported? Why is this reporting appropriate?

M81
Number 5 (Estimated time — — 15 to 25 minutes)

Many companies have pension plans for their employees. Accounting for the cost of pension plans is a complex subject in which many technical terms are encountered.

Required:
a. Describe normal cost.

b. Describe vested benefits. Include in your discussion what the actuarially computed value of vested benefits represents.

c. How should actuarial gains and losses directly related to the operation of a pension plan be accounted for?

d. What disclosures concerning pension plans should be made in the company's financial statements or notes?
Selected Questions

VII. Cost Accumulation, Planning, and Control

M83
Number 4 (Estimated time — — 15 to 25 minutes)

Part a. Noble Manufacturing Company uses the weighted-average method of process costing when computing manufacturing cost per equivalent unit. The work-in-process inventory at the beginning of the period was complete as to materials, and one-third complete as to conversion costs. The work-in-process inventory at the end of the period was complete as to materials, and one-quarter complete as to conversion costs.

Required:
1. Describe how the cost of the beginning work-in-process inventory is handled using the weighted-average method of process costing when computing manufacturing cost per equivalent unit. Do not describe determination of equivalent units.
2. Identify the conditions under which the weighted-average method of process costing would be inappropriate.
3. Specify the advantages of the weighted-average method of process costing in contrast to the first-in, first-out method.
4. How would Noble compute the amount of the conversion cost portion of its ending work-in-process inventory using the weighted-average method?

Part b. Daly Company has determined the number of units of Product Y that Daly would have to sell in order to break even. However, Daly would like to attain a 20 percent profit on sales of Product Y.

Required:
1. Explain how breakeven analysis can be used to determine the number of units of Product Y that Daly would have to sell to attain a 20 percent profit on sales.
2. If variable cost per unit increases as a percentage of the sales price, how would that affect the number of units of Product Y that Daly would have to sell in order to break even and why?
3. Identify the limitations of breakeven analysis in managerial decision-making.

M82
Number 5 (Estimated time — — 15 to 25 minutes)

Part a. Stein Company is going to use a predetermined annual factory overhead rate to charge factory overhead to products. In conjunction with this, Stein Company must decide whether to use direct labor hours or machine hours as the overhead rate base.

Required:
Discuss the objectives and criteria that Stein Company should use in selecting the base for its predetermined annual factory overhead rate.

Part b. Meyer Company's cost accounting department has prepared a factory overhead variance analysis report using the two-variance method. The plant manager of Meyer Company is interested in understanding the managerial usefulness of this report.

Required:
1. What are the purposes of a factory overhead variance analysis report?
2. Identify and explain the underlying assumptions associated with the two-variance method. Discuss the significance of each variance.
M81
Number 2 (Estimated time — — 15 to 25 minutes)

Part a. A company is presently using the payback method for evaluating capital budgeting projects and is considering using other more sophisticated capital budgeting techniques. The president has requested an explanation of the advantages and disadvantages of the payback method.

Required:
1. State the advantages and disadvantages of the payback method.
2. What other capital budgeting techniques could be used?

Part b. A company is presently using breakeven analysis. The president has requested an explanation of this analytical tool.

Required:
1. What is the breakeven point and how is it computed?
2. What are the major uses of breakeven analysis?

VIII. Not-for-Profit and Governmental Accounting

N84
Number 5 (Estimated time — — 15 to 25 minutes)

The accounting system of the municipality of Kemp is organized and operated on a fund basis. Among the types of funds used are a general fund, a special revenue fund, and an enterprise fund.

Required:

a. Explain the basic differences in revenue recognition between the accrual basis of accounting and the modified accrual basis of accounting as it relates to governmental accounting.

b. What basis of accounting should be used for each of the following funds:
   - General fund.
   - Special revenue fund.
   - Enterprise fund.

Why?

c. How should fixed assets and long-term liabilities related to the general fund and to the enterprise fund be accounted for?

d. How should the balance sheets of the general fund, the special revenue fund, and the enterprise fund be handled when preparing the comprehensive annual financial report (CAFR)? Why?

N81
Number 3 (Estimated time — — 15 to 25 minutes)

Governmental accounting gives substantial recognition to budgets, with those budgets being recorded in the accounts of the governmental unit.

Required:

a. What is the purpose of a governmental accounting system and why is the budget recorded in the accounts of a governmental unit? Include in your discussion the purpose and significance of appropriations.

b. Describe when and how a governmental unit records its budget, and closes it out.
SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

M84
Answer 4 (10 points)

a. Consolidated financial statements for Golden and Bridge should be presented for 1983. Golden acquired a controlling interest (as a general rule, ownership of over 50 percent of the outstanding voting shares of another company) when it acquired for cash (purchased) all of the shares of outstanding stock of Bridge. Presenting consolidated financial statements would be the most meaningful presentation in these circumstances, especially since Golden and Bridge are in similar lines of business.

b. Because Golden’s acquisition of Bridge should be accounted for as a purchase, the excess of the cash paid by Golden over the book value of Bridge of $47 million ($101 million - $54 million) should be allocated to the assets acquired and liabilities assumed.

First, all the identifiable assets acquired and liabilities assumed in the purchase should be assigned a portion of the cost of Bridge, normally equal to the market (fair) values at the date of the purchase. All of the market (fair) values of the assets acquired and liabilities assumed were the same as their book values except property, plant, and equipment, net of accumulated depreciation; so, as a result, $31 million ($93 million - $62 million) of the excess should be added to property, plant, and equipment. Depreciation on the excess would be charged over the estimated useful lives of the property, plant, and equipment using the accounting method applicable to the underlying property.

Second, the remainder of the excess ($16 million) should be recorded as goodwill, and amortization would be charged over the period to be benefited but not to exceed forty years at a straight-line rate, because the goodwill at any one date is assumed to eventually disappear.

c. The dividends of $400,000 received during 1983 from the marketable equity securities held by Golden should be accounted for as dividend income because income is realized when a portion of the investee’s income is distributed to the investor.

The sale during 1983 of $10 million of the marketable equity securities held by Golden for $10.2 million should be accounted for as a realized gain of $200,000 and included in the determination of net income for 1983.

The remaining marketable equity securities portfolio held by Golden should be accounted for at its market value of $2.5 million by establishing a valuation allowance and, since the portfolio is a current asset, charging in the income statement the amount by which the cost exceeds the market value ($500,000). As a result, Golden would have to consider reporting deferred income taxes in its balance sheet and income statement. Because of the uncertainty of recovery, it is conservative to carry a marketable equity securities portfolio at market value when market value is below cost.

N83
Answer 4 (10 points)

a. Inventories are presented appropriately as a current asset in the current assets section of the balance sheets.

Cost of goods sold is presented appropriately in the statements of income as a separate item of costs and expenses to arrive at income from continuing operations because it is part of the continuing operations. Inventories are presented appropriately in the summary of significant accounting policies because the accounting policy regarding inventories, lower of cost (first-in, first-out) or market is disclosed.

Inventories are presented appropriately in the note to financial statements on inventories because the following items are disclosed:

- The composition of the inventories.
- The reduction of inventories from cost to market at December 31, 1982, which is an adjustment that due to its significance should be adequately disclosed in the notes to the financial statements.
- The fact that the cost of inventories at December 31, 1981, approximated their market value.
b. 1. The components of the quick (acid-test) ratio are as follows:
   - The quick assets that make up the numerator are cash, short-term marketable securities, short-term notes receivable, and accounts receivable. In the Pace Company current assets section of balance sheets it would be the cash, the marketable securities, and the accounts receivable.
   - Total current liabilities is the denominator.

   2. The quick (acid-test) ratio tests the ability to meet sudden demands upon liquid current assets. It is used as a test of immediate liquidity by short-term creditors and others.

c. The provision for deferred income taxes should not be included in the statements of income in "Other, net." Deferred income taxes are part of income taxes and should be presented in the statements of income in "income taxes."

   The breakdown between current income taxes and deferred income taxes should be presented in the statements of income or disclosed in the notes to the financial statements. If the breakdown between current income taxes and deferred income taxes is disclosed in the notes to the financial statements, it should be disclosed in the note on deferred income taxes, not in summary of significant accounting policies.

d. The accounting change is a change in estimate, not a change in principle, and should not be included in the statements of income separately as "cumulative effect, less applicable income taxes of $1,500,000." The effect of the change should be reflected in depreciation expense in the current and future years as a separate component of income from continuing operations before income taxes because it is a material event that is usual but infrequently occurring. "Income taxes" should be adjusted each year. A separate per share amount for this change should not be presented in the statements of income under "earnings per share of common stock."

N81
Answer 4

Part a.

1. Whit Company should allocate the purchase price to the assets acquired and liabilities assumed. First, all identifiable assets acquired, either individually or by type, and liabilities assumed in the business combination, whether or not shown in the financial statements of Berry Company, should be assigned a portion of the cost of Berry Company, normally equal to their fair values at the date of acquisition.

   Goodwill is determined as the excess of the purchase price over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed.

2. In deciding upon consolidation policy, the aim should be to make the financial presentation that is most meaningful in the circumstances. Berry Company should be included in the entity’s consolidated financial statements from the date of the purchase.

   The usual condition for consolidation is control as evidenced by ownership of a majority voting interest. Therefore, as a general rule, ownership by one company, directly or indirectly, of over 50 percent of the outstanding voting shares of another company is a condition pointing toward consolidation.

M81
Answer 3 (10 points)

a. The historical cost/constant dollar method of accounting is based on measures of historical prices in dollars, each of which has the same general purchasing power.

   Historical cost amounts outdated in terms of current prices are restated on a current basis by the application of the Consumer Price Index for all Urban Consumers to the historical cost amounts.

   Measurements of historical cost/constant dollar amounts are computed by multiplying the components of the historical cost/nominal dollar measurements by the average level of the Consumer Price Index for the current fiscal year (or the level of the index at the end of the year if comprehensive financial statements are presented) and dividing the result by the level of the index at the date on which the measurement of the associated items was established (that is, the date of acquisition or the date of any measurement not based on historical cost).

b. The principal advantage of the historical cost/constant dollar method of accounting over the historical cost method is that it assists in the analysis of the effects of changing general price levels. In a period of rising prices, the historical cost method of accounting matches dollars of different purchasing power on the income statement.

c. The current cost method of accounting is based on measuring and reporting assets and expenses associated with the use or sale of assets at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale.

d. Depreciation expense using the current cost method of accounting would differ from depreciation expense using the historical cost method of accounting because depreciation expense is based on the current rather than historical cost of the fixed asset involved.

   In a period of rising prices, depreciation expense is likely to be higher using the current cost method of accounting because the current cost of the fixed asset is likely to be higher.
II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

**M85**

**Answer 3 (10 points)**

a. 1. For the interest-bearing note receivable, the interest income for 1984 should be determined by multiplying the principal (face) amount of the note by the note's rate of interest by one half (July 1, 1984, to December 31, 1984). Interest accrues with the passage of time, and it should be accounted for as an element of income over the life of the note receivable.

2. For the non-interest-bearing note receivable, the interest income for 1984 should be determined by multiplying the carrying value of the note by the prevailing rate of interest at the date of the note by one third (September 1, 1984, to December 31, 1984). The carrying value of the note at September 1, 1984, is the maturity amount discounted for two years at the prevailing interest rate from the maturity date of August 31, 1986, back to the issuance date of September 1, 1984. Interest, even if unstated, accrues with the passage of time, and it should be accounted for as an element of income over the life of the note receivable.

b. The interest-bearing note receivable should be reported at December 31, 1984, as a current asset at its principal (face) amount. The non-interest-bearing note receivable should be reported at December 31, 1984, as a noncurrent asset at its face amount less the unamortized discount on the note at December 31, 1984.

c. Because the trade accounts receivable are assigned on a with-recourse, nonnotification basis, Marie is responsible for collection and assumes the risks of any losses. Marie should account for the subsequent collections on the assigned trade accounts receivable by debiting cash and crediting accounts receivable assigned. The cash collected should then be remitted to Daniel Finance until the amount advanced by Daniel Finance is settled. The payments to Daniel Finance consist of both principal and interest with interest computed at the rate of 20 percent on the balance outstanding.

d. Because the trade accounts receivable were factored on a without-recourse basis, the factor is responsible for collection. On November 1, 1984, Marie should credit accounts receivable for the amount of trade accounts receivable factored, debit cash for the amount received from the factor, debit a receivable from the factor for 5 percent of the trade accounts receivable factored, and debit finance charges (an expense) for 3 percent of the trade accounts receivable factored.

**N84**

**Answer 3 (10 points)**

a. 1. For both the current and noncurrent marketable equity securities portfolios, the difference between the selling price and the cost is a realized gain or loss that should be included in the net income for the year because a gain or loss should be recognized at the culmination of the earning process, namely, in the year when realization (sale) takes place.

2. Victoria should account for both the current and noncurrent marketable equity securities portfolios at the lower of its aggregate cost or market value, determined at the balance sheet date. Because of the uncertainty of recovery, it is conservative to carry both the current and noncurrent marketable equity securities portfolios at market value when market value is below cost. The amount by which the aggregate cost of the portfolio exceeds the market value should be accounted for as a valuation allowance for both the current and noncurrent marketable equity securities portfolios.

For the current marketable equity securities portfolio, the change in the valuation allowance for the year should be included as a reduction in net income for the year because the portfolio is a current asset and the probability of realization of the loss is sufficiently high to justify inclusion in net income.

For the noncurrent marketable equity securities portfolio, the accumulated change in the valuation allowance should be included in the equity section of the balance sheet and shown separately. In the case of noncurrent marketable equity securities, it is argued that a decline in market value viewed as temporary should not be reflected in net income because the probability of realization is small.

b. Victoria should account for the disposition prior to their maturity of the long-term bonds called by their issuer by recognizing the difference between the call price and the net carrying value of the investment as a gain or loss that should be included in net income for the year because the earning process has been completed and realization has taken place.

c. Victoria should report the purchase price of the additional similar bonds as investment in long-term bonds—a noncurrent asset—and the two months' accrued interest as investment receivable—a current asset. The amount paid by Victoria for the two months' interest accrued between the last interest payment and the date of the purchase should not be included in the investment in long-term bonds because Victoria will receive this amount back when the next interest payment is made by the issuer of the bonds. As a result, interest income will be appropriately recognized for the period from the date of the purchase to the next interest payment date.
The added four stories is an addition, and its cost should be capitalized and classified with the capitalizable cost of the building. This cost should be depreciated over the remaining life of the original office building because that life is shorter than the estimated useful life of the addition.

b. The gain should be recognized on the sale of the land and building because income is realized whenever the earning process has been completed and the sale has taken place. The net book value at the date of sale would be composed of the capitalized cost of the land, the land improvement, and the building, as determined above, less the accumulated depreciation on the land improvement and the building. The excess of the proceeds received from the sale over the net book value at the date of sale would be accounted for as income from continuing operations in the income statement.

M83
Answer 2 (10 points)

a. Cash discounts should not be accounted for as financial income when payments are made. Income should be recognized when the earning process is complete (when Taylor sells the inventory). Furthermore, cash discounts should not be recorded when the payments are made because in order to properly match a cash discount with the related purchase, the cash discount should be recorded when the related purchase is recorded.

2. Cash discounts should not be accounted for as a reduction of cost of goods sold for period when payments are made. Cost of goods sold should be reduced when the earning process is complete (when Taylor sells the inventory). Furthermore, cash discounts should not be recorded when the payments are made because in order to properly match a cash discount with the related purchase, the cash discount should be recorded when the related purchase is recorded.

3. Cash discounts should be accounted for as a direct reduction of purchase cost because they reduce the cost of the inventories. Purchases should be recorded net of cash discount to reflect the net cash to be paid. The primary basis of accounting for inventories is cost, which represents the price paid or consideration given to acquire an asset.

b. Inventories would be lower using the LIFO inventory method instead of the FIFO method over a substantial time period when purchase prices of household appliances are rising because the inventories are at the oldest (lower) purchase prices instead of the most recent (higher) purchase prices. Correspondingly, cost of
goods sold would be higher because the cost of goods sold is at more recent (higher) purchase prices instead of older (lower) purchase prices. Consequently, net income and retained earnings would be lower.

More cash flow would generally be available using the LIFO inventory method instead of the FIFO method because taxable income is decreased, resulting generally in accrual and payment of lower income taxes. Correspondingly, income tax expense would generally be lower.

c. The lower of cost-or-market rule is used for valuing inventories when the FIFO method is used because of (a) the matching principle, that is, the decline in the utility of the household appliances inventories below its cost should be recognized as a loss in the current period, and (b) the concept of balance sheet conservatism.

NB2
Answer 2  (10 points)

Part a.

1. Carme Company should report a portion of the interest earned from the note receivable in 1981 (interest earned for the six-month period from July 1, 1981, to December 31, 1981) and a portion in 1982 (interest earned for the six-month period from January 1, 1982, to June 30, 1982). Interest accrues with the passage of time, and thus it should be accounted for as an element of income over the life of the note receivable.

2. First, determine the maturity value of the note receivable (the face value of the note receivable plus the interest income to be earned over the life of the note receivable [twelve-month period from July 1, 1981, to June 30, 1982]). Then, multiply the maturity value of the note receivable by one half of the discount rate (six-month period from December 31, 1981, to June 30, 1982) to arrive at the amount of the discount.

To account for the discounting transaction, cash would be debited for the amount received from the bank. Notes receivable would be credited for the face value of the note receivable. Interest expense for the discount would be debited and interest revenue for the interest income to be earned over the life of the note receivable would be credited. These latter two entries, however, are usually netted against each other instead of being recognized separately.

Part b.

1. The allowance method based on credit sales attempts to match bad debts with the revenues generated by the sales in the same period. Thus, it focuses on the income statement rather than the balance sheet.

On the other hand, the allowance method based on the balance in the trade receivables accounts attempts to value the accounts receivable at the end of a period at their future collectible amounts. Thus, it focuses on the balance sheet rather than the income statement.

It should be noted, however, that both the allowance method based on credit sales and the allowance method based on the balance in the trade receivables accounts are acceptable under generally accepted accounting principles.

2. Carme Company should report on its balance sheet at December 31, 1981, the balance in the allowance for bad debts account as a valuation or contra asset account; that is, a subtraction from the asset accounts receivable.

Bad debt expense may be presented in the income statement as a selling expense, general and administrative expense, financial expense, or as a subtraction to arrive at net sales.

M82
Answer 2  (10 points)

Part a.

The carrying amount of a marketable equity securities portfolio should be the lower of its aggregate cost or market value. At the end of its first year of operations, Key Company should report the current marketable equity securities portfolio in its balance sheet at cost ($500,000) and report no gain or loss in the income statement, because a gain should not be recognized until it is realized.

At the end of its second year of operations, Key Company should report the current marketable equity securities portfolio in its balance sheet at market value ($475,000) by establishing a valuation allowance and charging in the income statement the amount by which the aggregate cost exceeds the market value ($50,000). As a result, Key Company would generally need to report deferred income taxes in its balance sheet and income statement.

A realized gain ($20,000) should be reported in the income statement for the second year as a result of the sale of one security (cost $80,000) for $100,000 during the second year.

Carrying a marketable equity securities portfolio at original cost after its market value has declined has the effect of deferring recognition of the decline in the realizable value of such securities based on the expectation of a future market value recovery that may or may not occur. Because of the uncertainty of recovery, it is conservative to carry a marketable equity securities portfolio at market value when market value is below cost.

Part b.

Dynamic Company should follow the equity method of accounting for its investment in Cart Company because Dynamic Company is presumed, because of the size of
its investment, to be able to exercise significant influence over the operating and financial policies of Cart Company.

In 1981, Dynamic Company should report its interest in Cart Company's outstanding capital stock as a long-term investment. Following the equity method of accounting, Dynamic Company should record the cash purchase of 40 percent of Cart Company at cost, which is the amount paid.

Forty percent of Cart Company's total net income from July 1, 1981, to December 31, 1981, should be added to the carrying amount of the investment in Dynamic Company's balance sheet and shown as revenue in its income statement to recognize Dynamic Company's share of the net income of Cart Company after the date of acquisition. This amount should reflect adjustments similar to those made in preparing consolidated statements, including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between Dynamic Company's cost and the underlying equity in net assets of Cart Company on July 1, 1981.

The cash dividends paid by Cart Company to Dynamic Company should reduce the carrying amount of the investment in Dynamic Company's balance sheet and have no effect on Dynamic Company's income statement.

As a result of following the equity method of accounting, Dynamic Company would generally need to report deferred income taxes in its balance sheet and income statement.

**N81**

**Answer 5** (10 points)

a. Doherty Company has entered into a capital lease if at its inception the lease meets one or more of the following criteria:

1. The lease transfers ownership of the equipment to Doherty Company by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is equal to 75 percent or more of the estimated economic life of the leased equipment.
4. The present value of the minimum lease payments at the beginning of the lease term—excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by Lambert Company, including any profit thereon—equals or exceeds 90 percent of the amount by which the fair value of the equipment leased to Lambert Company at the inception of the lease exceeds any related investment tax credit that the Lambert Company retains and expects to realize.

The criteria in items 3 and 4 do not apply if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased equipment, including earlier years of use.

b. Lambert Company has entered into a sales-type lease or direct financing lease if at its inception the lease meets one or more of the criteria listed in a., above, and in addition, meets both of the following criteria:

1. The collectibility of the minimum lease payments is reasonably predictable.
2. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the Lambert Company under the lease.

c. In a sales-type lease, manufacturer's or dealer's profit is recognized and represents the excess of the fair value of the leased property over the cost at the inception of the lease.

In a direct financing lease, the cost and the fair value of the leased property are the same at the inception of the lease. Thus, the lessor has no manufacturer's or dealer's profit; instead, the lessor has only interest income that will be earned over the life of the lease.

**M81**

**Answer 4** (10 points)

a. If the terms of the purchase are f.o.b. shipping point (manufacturer's plant), Retail, Inc., should include in its inventory goods purchased from its suppliers when the goods are shipped. For accounting purposes, title is presumed to pass at that time.

b. Freight-in expenditures should be considered an inventoriable cost because they are part of the price paid or the consideration given to acquire an asset.

c. Because the cooking utensils were purchased three times during the current year, each time at a higher price than previously, Retail, Inc.'s ending inventory would be lower and the cost of goods sold would be higher using the weighted-average cost method instead of the FIFO method.

d. Because Retail, Inc., calculates the estimated cost of its ending inventory using the conventional (lower-of-cost-or-market) retail inventory method, net markdowns are excluded from the computation of the cost ratio and included in the computation of the ending inventory at retail. Net markdowns are excluded in order to approximate a lower-of-cost-or-market valuation. Excluding net markdowns from the computation of the cost ratio reduces the cost ratio, which in turn reduces the estimated cost of the ending inventory.

e. Products on consignment represents inventories owned by Retail, Inc., which are physically transferred.
to The Mall Space Company. Retail, Inc., retains title to the goods until their sale by The Mall Space Company.

The goods consigned are still included by Retail, Inc., in the inventory section of its balance sheet. Retail, Inc., reclassifies the inventory from regular inventory to consigned inventory. The Mall Space Company, on the other hand, reports neither inventory nor a liability in its balance sheet.

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

M85
Answer 2 (10 points)

a. When a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee, it should be capitalized by the lessee. The economic effect of such a lease on the lessee is similar, in many respects, to that of an installment purchase.

b. Lani should account for this 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 that portion of the payments representing executory costs, together with any profit thereon. However, if the amount so determined exceeds the fair value of the leased machine at the inception of the lease, the amount recorded as the asset and obligation should be the machine’s fair value.

c. Lani will incur interest expense equal to the interest rate used to capitalize the lease at its inception multiplied by the appropriate net carrying value of the liability.

In addition, Lani will incur an expense relating to amortization of the capitalized cost of the leased asset. This amortization should be based on the estimated useful life of the leased asset and amortized in a manner consistent with Lani’s normal depreciation policy for owned assets.

d. The asset recorded under the capital lease and the accumulated amortization should be reported on Lani’s December 31, 1984, balance sheet classified as noncurrent and should be separately identified by Lani in its balance sheet or footnotes thereto. The related obligation recorded under the capital lease should be reported on Lani’s December 31, 1984, balance sheet appropriately classified into current and noncurrent categories and should be separately identified by Lani in its balance sheet.

M85
Answer 4 (10 points)

a. The market price of the term bonds would be the sum of the present values of all of the expected net future cash flows discounted at an effective annual interest rate (yield) of 10 percent. The net future cash outflows are the maturity amount (face value) and the series of future semiannual interest payments adjusted for accrued interest received.

The market price of the serial bonds would be determined by computing the market price for each serial separately in the same way that a term bond would be determined and then totaling these prices for the various serials.

b. 1. Immediately after the term bond issue was sold, the current asset—cash—would be increased by the proceeds from the sale of the term bond issue. A noncurrent liability—term bonds payable—would be presented in the balance sheet at the face value of the term bonds, plus the premium. In addition, a current liability—accrued interest payable—would be presented in the balance sheet for accrued interest received (September 1, 1984, to October 1, 1984).

2. Immediately after the serial bond issue was sold, the current asset—cash—would be increased by the proceeds from the sale of the serial bond issue. A noncurrent liability—serial bonds payable—would be presented in the balance sheet at the face value of the serial bonds, less the discount.

c. The bond issue costs incurred in preparing and selling the bond issue could be accounted for as a noncurrent asset—deferred charge. The bond issue cost would then be amortized over the period the bonds will be outstanding, that is, the period from the date of sale (October 1, 1984) to the maturity date (March 1, 1989).

Alternately, under Statements of Financial Accounting Concepts, the bond issue costs incurred in preparing and selling the bond issue could be either accounted for as an expense in 1984, or as a reduction of the noncurrent liability—term bonds payable—and accounted for the same as debt discount.

d. To determine the amount of interest expense for the term bonds for 1984, the net carrying value of the term bonds on October 1, 1984, would be multiplied by the effective interest rate (yield) of 10 percent by one fourth (October 1, 1984, to December 31, 1984).

To determine the amount of interest expense for the serial bonds for 1984, the net carrying value of the serial bonds on November 1, 1984, would be multiplied by the effective interest rate (yield) of 11 percent by one sixth (November 1, 1984, to December 31, 1984).
N84
Answer 2 (10 points)

a. Angela should report the estimated loss from the safety hazard as an expense in the income statement and a liability in the balance sheet because both of the following conditions were met:

- It is considered probable that liabilities have been incurred.
- Based on past experience, a reasonable estimate of the amount of loss can be made.

In addition, Angela should disclose the nature of the safety hazard in the notes to the financial statements.

b. Angela should not report the estimated loss from the noninsurable flood risk as an expense in the income statement or a liability in the balance sheet because no losses have occurred since the warehouse has been uninsured and the asset has not been impaired. Thus, a loss has not been recognized and a liability does not exist. Furthermore, disclosure of the noninsurable risk in the notes to the financial statements is not required because no losses have occurred since the warehouse has been uninsured. Disclosure in the notes to the financial statements is, however, permitted.

c. The purchase of the movie tickets should be accounted for by debiting an asset account — movie tickets inventory — and crediting cash. An accrual for the estimated promotion expense and liability should be accounted for by debiting promotion expense and crediting an accrued liability for those costs associated with 60 percent of the coupons issued. The coupons actually redeemed this year should be accounted for by debiting the accrued liability and crediting the asset account — movie tickets inventory — for 40 percent of the coupons.

M84
Answer 3 (10 points)

a. 1. The selling price of the bond would be the present value of all of the expected net future cash outflows discounted at the effective annual interest rate (yield) of 10 percent. The present value is the sum of the present value of its maturity amount (face value) plus the present value of the series of future semiannual interest payments.

2. Immediately after the bond issue is sold, the current asset, cash, would be increased by the proceeds from the sale of the bond issue. A noncurrent liability, bonds payable, would be presented in the balance sheet at the face value of the bonds less the discount. The bond issue costs incurred in preparing and selling the bond issue would be classified as a noncurrent asset, deferred charge, under generally accepted accounting principles; however, there is theoretical justification for classifying the bond issue costs as either an expense or a reduction of the related debt liability.

b. The following items related to the bond issue would be included in Wesley’s 1983 income statement:

- Interest expense would be included for ten months (March 1, 1983, to December 31, 1983) at an effective interest rate (yield) of 10 percent. This is composed of the nominal interest of 8 percent adjusted for the amortization of the related bond discount. Bond discount should be amortized using the interest method over the period the bonds will be outstanding, that is, the period from the date of issue (March 1, 1983) to the maturity date (March 1, 1988).

- Interest expense (or bond issue expense) would be included for ten months of amortization of bond issue costs (March 1, 1983, to December 31, 1983). Bond issue costs should be amortized over the period the bonds will be outstanding, that is, the period from the date of sale (March 1, 1983) to the maturity date (March 1, 1988). However, there is theoretical justification for classifying the total bond issue costs as an expense.

c. The amount of bond discount amortization would be lower in the second year of the life of the bond issue. The interest method of amortization uses a uniform interest rate based upon a changing carrying value and provides for increasing amortization each year.

d. The retirement of the bonds would result in a loss from extinguishment of debt that should be included in the determination of net income and classified as an extraordinary item, net of related income tax effect.

N83
Answer 5 (10 points)

a. A lease should be classified as a capital lease when it transfers substantially all of the benefits and risks inherent to the ownership of property by meeting any one of the four criteria established by FAS 13 for classifying a lease as a capital lease.

Lease J should be classified as a capital lease because the lease term is equal to 80 percent of the estimated economic life of the equipment, which exceeds the 75 percent or more criterion.

Lease K should be classified as a capital lease because the lease contains a bargain purchase option.

Lease L should be classified as an operating lease because it does not meet any of the four criteria for classifying a lease as a capital lease.

b. For Lease J, Borman Company should record as a liability at the inception of the lease an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing ex-
ecutory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon. However, if the amount so determined exceeds the fair value of the equipment at the inception of the lease, the amount recorded as a liability should be the fair value.

For Lease K, Borman Company should record as a liability at the inception of the lease an amount determined in the same manner as for Lease J, and the payment called for in the bargain purchase option should be included in the minimum lease payments.

For Lease L, Borman Company should not record a liability at the inception of the lease.

c. For Lease J, Borman Company should allocate each minimum lease payment between a reduction of the liability and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the liability.

For Lease K, Borman Company should allocate each minimum lease payment in the same manner as for Lease J.

For Lease L, Borman Company should charge minimum lease (rental) payments to rental expense as they become payable.

M83
Answer 5 (10 points)

Part a.

For Type A merchandise, the estimated product warranty costs should be accrued by a charge to income and a credit to a liability because both of the following conditions were met:

1. It is probable that a liability has been incurred based on past experience. Thus, the matching principle is being followed.

2. The amount of loss can be reasonably estimated as 1 percent of sales.

For Type B merchandise, the estimated product warranty costs should not be accrued by a charge to income because the amount of loss cannot be reasonably estimated.

Part b.

The probable judgment ($400,000) should be accrued by a charge to income and a credit to a liability because both of the following conditions were met:

1. It is probable that a liability has been incurred because Carpenter's lawyer states that it is probable that Carpenter will lose the suit.

2. The amount of loss can be reasonably estimated because Carpenter's lawyer states that the most probable judgment is $400,000.

Thus, the principle of conservatism is being followed.

Carpenter should disclose the following in its financial statements or notes:

- The amount of the suit ($2 million)
- The nature of the accrual
- The nature of the contingency
- The range of loss ($200,000 to $900,000)

N82
Answer 3 (10 points)

a. Under the book value method, the carrying value of the convertible bonds at the date of the conversion (the bonds payable less the unamortized discount at that date) would be used to account for the conversion, and there would be no gain or loss recognized on the conversion.

The book value method views the convertible bonds as equity capital, and thus the conversion represents the completion of a prior transaction (the issuance of the convertible debt), not the culmination of an earning process.

Under the market value method, the market value of the common stock at the date of the conversion ($110 per share) would be used to account for the conversion. If the market value of the common stock at the date of the conversion exceeded the carrying value of the convertible bonds at that date, a loss would be recognized on the conversion. If the carrying value of the convertible bonds at the date of the conversion exceeded the market value of the common stock at that date, a gain would be recognized on the conversion.

The market value method views the convertible bonds as debt whose conversion was a significant economic transaction, and thus the conversion represents the culmination of an earning process. Furthermore, the market value method views the market value of the common stock at the date of the conversion to be the proper measurement at which to carry the common stock.

b. The nonconvertible term bonds were sold at a discount because the effective interest rate (yield) of 16 percent was higher than the stated interest rate of 14 percent. Although the bonds provide for the payment of interest of 14 percent, this rate was less than the prevailing or market rate for bonds of similar quality at the time the issue was sold. As a result, the bonds sold on the market at a price less than their par value.

c. The effects associated with the nonconvertible term bonds on Aubrey Company's 1982 income statement are as follows:

- Interest expense for eight months (May 1, 1982, to December 31, 1982) would be included in Aubrey Company's 1982 income statement. Interest accrues
with the passage of time, and the bonds were outstanding for only eight months in 1982.

- Interest expense would be increased for the amortization of bond discount from May 1, 1982 (the date of sale) to December 31, 1982. Amortization of bond discount is justified on the basis of the matching principle. Bond discount should be amortized using the interest method over the period the bond is outstanding, that is, the period from the date of sale to maturity date.

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

M33
Answer 3 (10 points)

a. The adjustment for an extraordinary item of $14 million should not be presented as a prior period adjustment in the Lynch Company Statement of Retained Earnings. The extraordinary item should be included in net income and presented in the income statement as a separate item, net of income taxes because net income should reflect all items of profit and loss recognized during the period. Furthermore, the amount of income taxes netted to arrive at the $14 million should be presented in the income statement.

The adjustment for correction of error in the financial statements of prior periods of $11 million in 1981 should not be presented in the portion of the Lynch Company Statement of Retained Earnings with the activity during the year. A correction of an error should be reported as a prior period adjustment. It should be presented in the Lynch Company Statement of Retained Earnings as "adjustment for correction of error" between "retained earnings at beginning of period, as previously reported" and "retained earnings at beginning of period, as restated." Furthermore, the amount of income taxes netted to arrive at the $11 million should be presented in the Lynch Company Statement of Retained Earnings.

The 10 percent stock dividend of $20 million is presented appropriately in the Lynch Company Statement of Retained Earnings. In accounting for a small stock dividend, retained earnings are debited for the market value of the stock at the date of the stock dividend, common stock is credited for the par value of the stock, and the difference is credited to additional paid-in capital. Total stockholders' equity does not change; but recognition has been made of a capitalization of retained earnings equivalent to the fair value of the additional shares resulting from the stock dividend.

The treasury stock of $6 million should not be presented in the Lynch Company Statement of Retained Earnings. Under the cost method of accounting for treasury stock transactions, the cost of the stock (market value on the date of the purchase) should be debited to treasury stock and presented as a separate item in the Lynch Company Statement of Stockholders' Equity because it is an unallocated reduction of stockholders' equity.

b. The additional facts above concerning the stock dividend and treasury stock transaction affected the cash dividend per share (pay-out) ratio because the earnings per share of common stock was affected as follows:

- The 10 percent stock dividend decreased the earnings per share because there were more shares outstanding after the 10 percent stock dividend; thus the cash dividend per share (pay-out) ratio was increased.
- The treasury stock transaction increased the earnings per share because there were less shares outstanding after the treasury stock transaction (treasury stock is not part of outstanding common stock and no dividends are paid out on treasury stock); thus the cash dividend per share (pay-out) ratio was decreased.

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M05
Answer 5 (10 points)

a. Some transactions affect the determination of net income for accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. In accordance with the matching principle, the appropriate income tax expense represents the income tax consequences of revenues and expenses recognized for accounting purposes in the current period, whether those income taxes are paid or payable in current, future, or past periods.

b. When depreciation expense for certain machinery purchased this year is reported using the accelerated cost recovery system (ACRS) for income tax purposes and the straight-line basis for accounting purposes, a timing difference arises. Because more depreciation ex-
pense is reported for income tax purposes than for accounting purposes this year, pretax accounting income would be more than taxable income. The difference would create a credit to deferred income taxes equal to the difference in depreciation multiplied by the appropriate income tax rate.

When rent revenues received in advance this year are included in this year’s taxable income and as unearned revenues, i.e., a current liability, for accounting purposes, a timing difference arises. Because rent revenues are reported this year for income tax purposes but not for accounting purposes, pretax accounting income would be less than taxable income. The difference would create a debit to deferred income taxes equal to the difference in rent revenues multiplied by the appropriate income tax rate.

c. The income tax effect of the depreciation timing difference should be classified on the balance sheet as a noncurrent liability because the asset to which it is related is noncurrent. The income tax effect of the rent revenues received in advance timing difference should be classified on the balance sheet as a current asset because the liability to which it is related is current.

The noncurrent liability and the current asset should not be netted on the balance sheet because one is current and one is noncurrent.

On the income statement, the income tax effect of the depreciation timing difference and the rent revenues received in advance timing difference should be netted. This amount should be classified as a deferred component of income tax expense.

M84
Answer 4 (10 points)

a. Morgan should recognize the change in depreciation method by including the cumulative effect of changing to a new accounting principle in net income of the period of the change.

The amount of cumulative effect 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 applied retroactively for all prior periods that would have been affected. This difference reflects only the direct effects of the change and the related income tax effect. The amount of the cumulative effect, net of income taxes, should be shown as a separate item in the income statement between the captions “extraordinary items” and “net income.” Pro forma disclosure of the effect of retroactive restatement should be shown on the face of the income statement.

b. The effects of the hailstorm should be reported as an extraordinary item in the income statement because it meets both of the criteria for classification as an extraordinary item. It is unusual in nature and infrequent in occurrence, taking into account the environment in which the entity operates.

c. The classification in the income statement of an extraordinary item differs from that of an operating item in the following ways. First, an extraordinary item should be shown as a separate item in the income statement below the continuing operations section of the income statement. Second, an extraordinary item should be shown net of applicable income taxes. An extraordinary item is unrelated to Morgan’s normal and on-going operations.

M84
Answer 5 (10 points)

a. 1. The annual provision for pension cost is the normal cost and the past service cost, including amortization thereon and/or interest.

2. Amortization of past service cost is not generally included in calculating the minimum limit. An amount equal to interest on any unfunded prior service cost is included in calculating the minimum limit and, in addition, in certain cases some provision for vested benefits.

Amortization of past service cost is included in calculating the maximum limit by an amount of 10 percent (until fully amortized).

b. 1. For a compensatory stock option plan for which the date of grant and the measurement date are the same, deferred compensation costs should be recognized in the income statement of each period in which services are rendered. This serves to match the compensation expense with the related revenues in conformity with the matching principle.

2. For a compensatory stock option plan for which the date of grant is before the measurement date, deferred compensation costs should be estimated until the measurement date so that compensation costs are recognized in the income statement of each period in which services are rendered. This serves to match the compensation expense with the related revenues in conformity with the matching principle.

c. Carol will accrue a liability for compensation for future vacations if all of the following conditions are met:

- Carol’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.

This serves to match the vacation benefits with the period in which services are rendered and results in a liability that has been incurred and is measurable.
Accounting Theory

N83
Answer 3 (10 points)

a. Michael Company should earn revenue as it performs the work on the contract (the percentage-of-completion method) because the right to revenue is established and collectibility is reasonably assured. Furthermore, the use of the percentage-of-completion method avoids distortion of income from period to period and provides for better matching of revenues with the related expenses.

b. Progress billings would be accounted for by increasing accounts receivable and increasing progress billings on contract, a contra-asset account that is offset against the construction costs in progress account. If the construction-costs-in-progress account exceeds the progress-billings-on-contract account, the two accounts would be shown in the current asset section of the balance sheet. If the progress-billings-on-contract account exceeds the construction-costs-in-progress account, the two accounts would be shown, in most cases, in the current liabilities section of the balance sheet.

c. The income recognized in the second year of the four-year contract would be determined using the cost-to-cost method of determining percentage of completion as follows:

- First, the estimated total income from the contract would be determined by deducting the estimated total costs of the contract (the actual costs to date plus the estimated cost to complete) from the contract price.
- Second, the actual costs to date would be divided by the estimated total costs of the contract to arrive at a percentage completed, which would be multiplied by the estimated total income from the contract to arrive at the total income recognized to date.
- Third, the total income recognized in the second year of the contract would be determined by deducting the income recognized in the first year of the contract from the total income recognized to date.

d. Earnings per share in the second year of the four-year contract would be higher using the percentage-of-completion method instead of the completed-contract method because income would be recognized in the second year of the contract using the percentage-of-completion method, whereas no income would be recognized in the second year of the contract using the completed-contract method.

N82
Answer 5 (10 points)

a. The change in depreciation method from the double-declining-balance method to the straight-line method constitutes a change in accounting principle and is presented appropriately in David Company's statements of income for the year ended December 31, 1981, and December 31, 1980. The effect of applying the straight-line method for both the year of and the year after the change should be included in cost of goods sold because the periods subsequent to the change should be reported on the basis of the newly adopted accounting principle to assure comparability. The cumulative effect on prior years of the change should not be presented in the continuing operations section of the income statement because it is not part of the continuing operations of David Company.

The loss from operations of the discontinued Dex Division from January 1, 1981, to September 30, 1981 (the portion of the year prior to the measurement date) and from January 1, 1980, to December 31, 1980, should not be presented in the continuing operations section of the income statement. For comparability purposes, each should be presented in the income statement after income from continuing operations as a separate item, less applicable income taxes, because it is not part of the continuing operations of David Company.

David Company's statements of income should be corrected as follows:

- "Other, net" and "total costs and expenses" should be decreased to exclude the loss from operations of the discontinued Dex Division.
- "Income from continuing operations before income taxes" should be increased to exclude the loss from operations of the discontinued Dex Division.
- "Income taxes" should be increased to exclude the tax reduction applicable to the loss from operations of the discontinued Dex Division.
- "Income from continuing operations" should be increased to exclude the loss from operations of the discontinued Dex Division, less applicable income taxes.
- A new caption, "discontinued operations," should be added.
- A new subcaption, "loss from operations of the discontinued Dex Division, less the amount of applicable income taxes," should be added under the caption "discontinued operations."
- The subcaption, "loss on disposal of Dex Division, including provision of $1,500,000 for operating losses during phase-out period, less applicable income taxes of $8,000,000," should be under the caption "discontinued operations."
- "Earnings per share of common stock" should be presented on the face of the income statement for income from continuing operations. As for income from discontinued operations, earnings per share of common stock may be presented on the face of the income statement or in the notes to the financial statements.

b. The price-earnings ratio is of particular interest to investors for evaluating stock price because it relates the earnings of the business to the current market price.
of the stock. Other internal and external factors besides earnings would also influence the current market price of the stock and hence the price-earnings ratio.

The price-earnings ratio for 1981 is determined by dividing the market value per share by the earnings per share of common stock. The ratio generally would be computed on the basis of the earnings per share of common stock for income from continuing operations.

M82
Answer 3 (10 points)

a. A usual but infrequently occurring charge does not meet the unusual-in-nature criterion, and, thus, it is not an extraordinary item. Therefore, it is presented appropriately in the ordinary operations section of the income statement; however, it should have been reported as a separate item rather than as part of “selling, general and administrative expenses” because it meets the criteria of being material and infrequently occurring.

An extraordinary item should not be presented in the ordinary operations section of the income statement because it is not part of the ordinary operations of Horizon Company. An extraordinary item should be presented in the income statement as a separate item, net of income taxes. The Horizon Company Statements of Income and Retained Earnings should be revised as follows:

- “Other, net” and “total costs and expenses” should be decreased by $10,000,000 to exclude the extraordinary item (charge).
- “Income before income taxes” should be increased by $10,000,000 to exclude the extraordinary item (charge) and the caption “income before income taxes” should be changed to “income before income taxes and extraordinary item (charge).”
- “Income taxes” should be increased by $5,000,000 to exclude the income tax reduction applicable to the extraordinary item (charge).
- A new caption “income before extraordinary item (charge)” should be added ($25,200,000).
- A new caption “extraordinary item (charge)” should be added showing the extraordinary item (charge) of $10,000,000, applicable income taxes of $5,000,000, and the net extraordinary item (charge) of $5,000,000.

A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error and should be reported as a prior period adjustment. Therefore, the presentation in the foregoing Horizon Company Statements of Income and Retained Earnings is appropriate.

Because of the significance attached by investors and others to earnings-per-share data, together with the importance of evaluating the data in conjunction with the financial statements, earnings per common share should be shown on the face of the income statement. Furthermore, earnings per common share for income before extraordinary items should be presented as well as earnings per common share for net income.

b. The quick (acid-test) ratio tests the ability to meet sudden demands upon liquid current assets.

Inventory turnover provides information about the number of times inventory is replaced each year.

The return on stockholders' equity indicates the percentage return accruing to the owners based upon the book value of their interest in the company.

c. The quick (acid-test) ratio for 1981 is determined by dividing the sum of "cash" ($3,500,000), "marketable securities" ($13,000,000), and "accounts receivable" ($105,000,000) on the Horizon Company Balance Sheet by the "total current liabilities" ($75,000,000) on the Horizon Company Balance Sheet.

Inventory turnover for 1981 is determined by dividing the "cost of goods sold" ($480,000,000) on the Horizon Company Statements of Income and Retained Earnings by the average "inventory" ($126,000,000 and $154,000,000 + 2) during the year on the Horizon Company Balance Sheet. If possible, the average monthly inventory should be used.

The return on stockholders' equity for 1981 is determined by dividing the "net income" ($20,200,000) on the Horizon Company Statements of Income and Retained Earnings by the "total stockholders' equity" ($263,000,000) or the average "total stockholders' equity" ($263,000,000 and $255,000,000 + 2) on the Horizon Company Balance Sheet.

M82
Answer 4 (10 points)

Part a.

1. When profits or expenses are included in taxable income on the income tax return later or earlier than they are included on the income statement, a timing difference arises and deferred income taxes should be reported.

2. Gross profits on installment sales—Deferred income taxes would generally be recognized because gross profits on installment sales would generally be recognized in Lorac Company's income statement in the year of sale and recognized in its tax return when later collected.

Revenues on long-term construction contracts—Deferred income taxes could be recognized because revenues on long-term construction contracts could be recognized in Lorac Company's income statement on the percentage-of-completion basis and recognized in its tax return on the completed-contract basis.

Estimated costs of product warranty contracts—Deferred income taxes should be recognized because estimated costs of product warranty contracts should be
recognized in Lorac Company's income statement in the year of sale and recognized in its tax return when paid.

Premiums on officers' life insurance with Lorac as beneficiary—This is a permanent difference and deferred income taxes should not be recognized. Premiums on officers' life insurance with Lorac as beneficiary should be recognized in Lorac Company's income statement but are not a deductible expense in its tax return.

Part b.

Deferred income taxes related to a noncurrent asset or liability would be classified as a noncurrent item in the balance sheet. Deferred income taxes are related to an asset or liability if reduction of the asset or liability causes the timing difference to reverse.

Deferred income taxes that are not related to an asset or liability because (a) there is no associated asset or liability or (b) reduction of an associated asset or liability will not cause the timing difference to reverse would be classified based on the expected reversal date of the specific timing difference. An expected reversal date beyond one year (or the normal operating cycle) would require noncurrent classification of the deferred income taxes.

Deferred income taxes would be classified in the balance sheet as a noncurrent liability when the noncurrent deferred credits related to timing differences exceed the noncurrent deferred charges related to timing differences. Conversely, they would be classified in the balance sheet as a noncurrent asset when the noncurrent deferred charges related to timing differences exceed the noncurrent deferred credits related to timing differences.

VI. Other Financial Topics

N81
Answer 2 (10 points)

a. A change from the sum-of-the-years-digits depreciation method to the straight-line method for fixed assets is a change in accounting principle. The concept of consistency presumes that an accounting principle, once adopted, should not be changed in accounting for events and transactions of a similar type. A change is permissible only if the enterprise justifies the preference of an alternative acceptable accounting principle.

b. When pro forma disclosure is required for an accounting change, the pro forma amounts will include both the direct effects of the change and the nondiscretionary adjustments in items based on income before taxes or net income, such as profit-sharing expense and certain royalties, that would have been recognized if the newly adopted accounting principle had been followed in prior periods. Related income tax effects should be recognized for both direct effects of the change and nondiscretionary adjustments.

c. If a public company obtained additional information about the service lives of some of its fixed assets showing that the service lives previously used should be shortened, such a change would be a change in accounting estimate. The change in accounting estimate should be accounted for in the year of change and future years since the change affects both. Specifically, the operating item, depreciation expense, would be increased. In addition, the effect on income before extraordinary items, net income, and related per-share amounts of the current period should be disclosed.

d. Changing specific subsidiaries comprising the group of companies for which consolidated financial statements are presented is an example of change in the reporting entity (a special type of change in accounting principle). Such a change requires that the consolidated income statements be restated to reflect the different reporting entity.

N81
Answer 4

Part b.

1. The expenses related to effecting the business combination should be deducted in determining net income of the combined company for the period in which the expenses were incurred. Because the pooling-of-interests method records neither the acquiring of assets nor the obtaining of capital, expenses related to effecting a business combination accounted for as a pooling of interests are expenses of the combined company rather than additions to assets or direct reductions of stockholders' equity.

2. The results of operations for the year in which the business combination occurs should include the combined results of the separate companies from the beginning of the year to the date the combination is consummated and those of the combined operations from that date to the end of the year. This reporting is appropriate because in a pooling of interests two companies come together to form one company as though they had always been together.
M81
Answer 5 (10 points)
a. Normal cost is the annual cost assigned, under the actuarial cost method in use, to years subsequent to a particular valuation date.
b. Vested benefits are benefits that are not contingent on the employee's continuing in the service of the employer.

The actuarially computed value of vested benefits represents the present value, at the date of determination, of the sum of (a) the benefits expected to become payable to former employees who have retired, or who have terminated service with vested rights, at the date of determination; and (b) the benefits, based on service rendered prior to the date of determination, expected to become payable at future dates to present employees, taking into account the probable time that employees will retire, at the vesting percentage applicable at the date of determination.

c. Actuarial gains and losses directly related to the operation of a pension plan should be given effect in the provision for pension cost in a consistent manner that reflects the long-range nature of pension cost. Accordingly, they should be allocated to current and future periods by using the spreading or averaging method.

d. The following disclosures concerning pension plans should be made in the company financial statements or notes:

• A statement that pension plans exist, identifying or describing the employee groups covered.
• A statement of the company accounting and funding policies.
• The provision for pension cost for the period.
• The nature and effect of significant matters affecting comparability for all periods presented, such as changes in accounting methods, changes in circumstances, or adoption or amendment of a plan.

For defined benefit pension plans, the company should disclose for each complete set of financial statements the following data as of the most recent benefit information date for which the data are determinable and available:

• The actuarial present value of vested accumulated plan benefits.
• The actuarial present value of nonvested accumulated plan benefits.
• The plans’ net assets available for benefits.
• The assumed rates of return used in determining the actuarial present values of vested and nonvested accumulated plan benefits.
• The date as of which the benefit information was determined.

VII. Cost Accumulation, Planning, and Control

M83
Answer 4 (10 points)

Part a.

1. The weighted-average method of process costing combines beginning work-in-process inventory costs with costs of the new period by adding the cost of the work-in-process inventory at the beginning of the period to the costs of the new period.

2. The weighted-average method of process costing would be inappropriate when beginning and ending inventories change radically from month to month and conversion costs per unit change radically from month to month.

3. The weighted-average method of process costing is generally easier to use than the first-in, first-out method primarily because the beginning work-in-process inventory is averaged in as part of current production. Furthermore, if several unit cost figures are used at the same time, extensive detail is required in the first-in, first-out method, which can lead to complex procedures and even inaccuracy; and under such conditions the weighted-average method leads to more satisfactory cost computations.

The weighted-average method of process costing averages out uneven but expected cost incurrences over the entire period. This will reduce the fluctuations in unit costs and reflect operating experience for the period as a whole.

4. The units of the work-in-process inventory at the end of the period would be multiplied by one quarter (the portion complete as to conversion costs). The result would then be multiplied by the conversion cost per equivalent unit to arrive at the conversion cost portion of the ending work-in-process inventory.

Part b.

1. Daly would determine the number of units of Product Y that it would have to sell to attain a 20 percent profit on sales by dividing total fixed costs plus desired profit (20 percent of the sales price per unit multiplied by the units to attain a 20 percent profit) by unit contribution margin (sales price per unit less variable cost per unit).
2. If variable cost per unit increases as a percentage of the sales price, Daly would have to sell more units of Product Y to break even. Because the unit contribution margin (sales price per unit less variable cost per unit) would be lower, Daly would have to sell more units to cover the fixed costs.

3. The limitations of breakeven analysis in managerial decision-making are as follows:

- The breakeven chart is fundamentally a static analysis, and, in most cases, changes can only be shown by drawing a new chart or series of charts.
- The amount of fixed and variable cost, as well as the slope of the sales line, is meaningful in a defined range of activity and must be redefined for activity outside the relevant range.
- It is difficult to determine the fixed and variable components of cost.
- It is assumed that product mix will be unchanged.
- It is assumed that product technology will be unchanged.
- It is assumed that labor productivity will be unchanged.
- It is assumed that selling prices and other market conditions will be unchanged.

N82
Answer 4 (10 points)

Part a.

1. The direct costing method is useful for internal reporting because it focuses attention on the fixed-variable cost relationship and the contribution margin concept. It facilitates managerial decision-making, product pricing, and cost control. It allows certain calculations to be readily made, such as breakeven points and contribution margins. The focus on the contribution margin (sales revenues less variable costs) enables management to emphasize profitability in making short-run business decisions. Fixed costs are not easily controllable in the short run and hence may not be particularly relevant for short-run business decisions.

2. Assuming that the quantity of ending inventory is higher than the quantity of beginning inventory, operating income using direct costing would be lower than operating income using absorption costing. Direct costing excludes fixed manufacturing overhead from inventories as it considers such costs to be period costs, which are expensed immediately; whereas, absorption costing includes fixed manufacturing overhead in inventories as it considers such costs to be product costs, which are expensed when the goods are sold! When the quantity of inventory increases during a period, direct costing produces a lower dollar increase in inventory than absorption costing. As a result, operating income would be lower.

Part b.

1. Both the net present value method and the internal rate-of-return method have the following advantages over the payback method:

- Consider the time value of money.
- Consider cash flow over the entire life of the project.

2. The limitations of the net present value method are as follows:

- It is more difficult to use than other less sophisticated capital budgeting techniques.
- The discount rate (hurdle rate of return) must be determined in advance.
- Certainty about cash flow is assumed.
- Cash flows are reinvested at the discount rate (hurdle rate of return).

3. The limitations of the internal rate-of-return method are as follows:

- It is more difficult to use than other less sophisticated capital budgeting techniques.
- Cash flows are reinvested at the rate earned by the investment.
- Certainty about cash flow is assumed.

4. Depreciation is excluded from the calculations for both the net present value method and the internal rate-of-return method. Deduction of depreciation would constitute a double-counting of a cost that has already been considered as a lump-sum outflow (the initial cost of the asset). Both the net present value method and the internal rate-of-return method focus on cash flow, while depreciation is an allocation of past cost and is not a cash flow.

M82
Answer 5 (10 points)

Part a.

An objective in selecting the base for Stein Company's predetermined annual factory overhead rate is to ensure the application of factory overhead in reasonable proportion to a beneficial or causal relationship to products. Ordinarily, the base selected should be closely related to functions represented by the applied overhead cost. If factory overhead costs are predominantly labor-oriented, such as supervision and indirect labor, the proper base would probably be direct labor hours. If factory overhead costs are predominantly related to the costs incurred in the ownership and operation of the machinery, the proper base would probably be machine hours.

Another objective in selecting the base is to minimize clerical cost and effort relative to the benefits
attained. When two or more bases provide approximately the same applied overhead cost to specific units of production, the simplest base should be used.

A predetermined annual factory overhead rate provides a feasible method of computing product costs promptly enough to serve management needs, such as identifying inefficiencies and minimizing month-to-month distortions in unit costs created by uneven expenditure patterns.

Part b.

1. A factory overhead variance analysis report provides periodic identification of deviations from planned outcomes. It provides a basis for further analysis, investigation, and follow-up action. It is useful in developing budgets and standards for future operations. Variances can be used to identify changes in operations that need to be reflected in such activities as product pricing, compensation rates, maintenance levels, and so forth. The report can be helpful in identifying costs incurred that should be classified as losses rather than product costs.

2. The two-variance method breaks down the overall factory overhead variance—that is, the difference between the actual factory overhead and the factory overhead applied to production—into two components. They are (a) the controllable (budget) variance and (b) the volume (denominator) variance.

The controllable (budget) variance is the difference between the actual factory overhead and the budget allowance based on standard hours allowed. The department managers have the responsibility to exercise control over the costs to which the variances relate.

The volume (denominator) variance is the difference between the budget allowance based on standard hours allowed and the factory overhead applied to production. The variance indicates the cost of capacity available but not utilized or not utilized efficiently, and such variance is generally considered the responsibility of management.

M81
Answer 2 (10 points)

Part a.

1. The advantages of the payback method are these:

• It may be used to select those investments yielding a quick return of cash.
• It permits a company to determine the length of time required to recapture its original investment.
• The reciprocal of the payback period may be used under certain conditions as a rough approximation of the rate of return calculated by the internal rate-of-return method. The approximation is valid when the project’s life is long, approximately double or more than the payback period, and when the annual savings and/or cash inflow are relatively uniform in amount.

The disadvantages of the payback method are these:

• It ignores the time value of money.
• It ignores cash flow, including salvage value, which may be produced beyond the payback period.

2. Other capital budgeting techniques that could be used are the accounting rate-of-return (average annual return on investment) method, and the two discounted cash flow methods—net present value and internal rate of return.

Part b.

1. The breakeven point is that level of activity (sales) at which neither profit nor loss results. The factors used in determining the breakeven point are sales price, variable cost, and fixed cost.

The breakeven point in units is computed by dividing the total fixed cost by the unit contribution margin (sales price less variable cost). The breakeven point in dollars is computed by dividing the total fixed cost by the contribution margin ratio (sales price divided into contribution margin).

2. The major uses of breakeven analysis are these:

• It assists management in achieving profit objectives by enabling management to analyze fixed versus variable cost characteristics and production volumes.
• It assists management in formulating pricing and product mix decisions.
VIII. Not-for-Profit and Governmental Accounting

N84

Answer 5 (10 points)

a. In the accrual basis of accounting, revenues should be recognized in the accounting period in which they are earned and become measurable.

In the modified accrual basis of accounting, revenues should be recognized in the accounting period in which they become susceptible to accrual— that is, when they become both measurable and available to finance expenditures of the fiscal period. “Available” means collectible within the current period or soon enough thereafter to be used to pay current period liabilities.

b. For the general fund, the modified accrual basis of accounting should be used because it is a governmental fund, which is, in essence, an accounting segregation of financial resources.

For the special revenue fund, the modified accrual basis of accounting should be used because it is a governmental fund, which is, in essence, an accounting segregation of financial resources.

For the enterprise fund, the accrual basis of accounting should be used because it is a proprietary fund, whose ongoing organizations or activities are similar to the organizations or activities found in the private sector; or Kemp's governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

c. In the general fund, the fixed assets should be accounted for through the general fixed assets account group and the unmatured general long-term liabilities should be accounted for through the general long-term debt account group.

In the enterprise fund, both the fixed assets and the long-term liabilities should be accounted for in the enterprise fund.

d. When preparing the comprehensive annual financial report (CAFR), the balance sheets of the general fund, the special revenue fund, and the enterprise fund should be combined. The CAFR should contain a combined balance sheet for all fund types and account groups.

N81

Answer 3 (10 points)

a. A governmental accounting system must make it possible to

- Present fairly and with full disclosure, in conformity with generally accepted accounting principles, the financial position and results of financial operations of the funds and account groups of the governmental unit.
- Determine and demonstrate compliance with finance-related legal and contractual provisions.

Because the legislative body enacts the budget into law, the budget is recorded in the accounts of a governmental unit. This enables a governmental unit to show legal compliance with the budget by providing an accounting system that measures actual expenditures and obligations against amounts appropriated, and actual revenues against estimated revenues. Appropriations enacted into law constitute maximum expenditure authorizations during the fiscal year, and they cannot legally be exceeded unless subsequently amended by the legislative body.

b. As the new fiscal year begins, the budget, already enacted into law by the legislative body, is recorded. Budgetary accounts are set up to record the estimated revenues and appropriations in the fund accounts by debiting estimated revenues and crediting appropriations. If there is a difference between estimated revenues and appropriations, the excess or deficit is credited or debited, respectively, to fund balance. In addition, subsidiary ledger accounts are maintained for estimated revenues by source and for appropriation/expenditure items.

At the end of the fiscal year, the estimated revenues balance and the appropriations balance are closed out to fund balance.
EXAMINATION IN ACCOUNTING THEORY
(Theory of Accounts)
November 8, 1985; 1:30 to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>90</td>
<td>110</td>
</tr>
<tr>
<td>2</td>
<td></td>
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</tr>
<tr>
<td></td>
<td>Total</td>
<td>150</td>
<td>210</td>
</tr>
</tbody>
</table>

INSTRUCTIONS TO CANDIDATES
(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since 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.

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

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

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

Item

99. The financial statement which summarizes the financial position of a company is the
   a. Income statement.
   b. Balance sheet.
   c. Statement of changes in financial position.
   d. Retained earnings statement.

Answer Sheet

99. a ○ c d

Items to be Answered

1. Under Statements of Financial Accounting Concepts, which of the following relates to both relevance and reliability?
   a. Timeliness.
   b. Neutrality.
   c. Feedback value.
   d. Consistency.

2. Under Statements of Financial Accounting Concepts, comprehensive income includes which of the following?
   a. Gains
   b. Gross margin

<table>
<thead>
<tr>
<th>Gains</th>
<th>Gross margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

3. When the allowance method of recognizing bad debt expense is used, the entry to record the specific write-off of an uncollectible account would decrease
   a. Net accounts receivable.
   b. Allowance for doubtful accounts.
   c. Net income.
   d. Working capital.

4. When computing purchasing power gains or losses, how is each of the following classified?
   <table>
   <tr><th>Allowance for doubtful accounts</th><th>Obligations under warranties</th></tr>
   <tr><td>a. Monetary</td><td>Nonmonetary</td></tr>
   <tr><td>b. Monetary</td><td>Monetary</td></tr>
   <tr><td>c. Nonmonetary</td><td>Monetary</td></tr>
   <tr><td>d. Nonmonetary</td><td>Nonmonetary</td></tr>
   </table>

5. At its inception, the lease term of Lease G is 65% of the estimated remaining economic life of the leased property. This lease contains a bargain purchase option. The lessee should record Lease G as
   a. Neither an asset nor a liability.
   b. An asset but not a liability.
   c. An asset and a liability.
   d. An expense.

6. For a lease that transfers ownership of the property to the lessee by the end of the lease term, the lessee should
   a. Record the minimum lease payment as an expense.
   b. Amortize the capitalizable cost of the property using the interest method.
   c. Amortize the capitalizable cost of the property in a manner consistent with the lessee's normal depreciation policy for owned assets except that the period of amortization should be the lease term.
   d. Amortize the capitalizable cost of the property in a manner consistent with the lessee's normal depreciation policy for owned assets.

7. Which of the following should be expensed as incurred by the franchisee for a franchise with an estimated useful life of ten years?
   a. Amount paid to the franchisor for the franchise.
   b. Periodic payments to a company, other than the franchisor, for that company's franchise.
   c. Legal fees paid to the franchisee's lawyers to obtain the franchise.
   d. Periodic payments to the franchisor based on the franchisee's revenues.

8. The premium on a three-year insurance policy expiring on December 31, 1985, was paid in total on January 1, 1983. Assuming that the original payment was initially debited to an expense account, and that appropriate adjusting entries have been recorded on December 31, 1983, and 1984, the balance in the prepaid asset account on December 31, 1984, would be
   a. Zero.
   b. Lower than the balance on December 31, 1985.
   c. The same as the original payment.
   d. The same as it would have been if the original payment had been initially debited to a prepaid asset account.
Accounting Theory

9. Magazine subscriptions collected in advance are reported as
   a. A contra account to magazine subscriptions receivable in the asset section of the balance sheet.
   b. Deferred revenue in the liability section of the balance sheet.
   c. Deferred revenue in the stockholders' equity section of the balance sheet.
   d. Magazine subscription revenue in the income statement in the period collected.

10. A machine was purchased in 1984. The straight-line depreciation method with a half-year's depreciation taken in the first year, was used for financial statement purposes and was less than the accelerated cost recovery system deduction taken for income tax purposes. Assume that the company is profitable, there are and have been no other timing differences, and the effective income tax rate is 40%. In the December 31, 1984, balance sheet, a noncurrent deferred income tax credit would be reported in the amount of
   a. 40% of the excess of the accelerated cost recovery system deduction over the straight-line depreciation method expense.
   b. 40% of the excess of the straight-line depreciation method expense over the accelerated cost recovery system deduction.
   c. 60% of the excess of the accelerated cost recovery system deduction over the straight-line depreciation method expense.
   d. 60% of the excess of the straight-line depreciation method expense over the accelerated cost recovery system deduction.

11. The lessee's balance sheet liability for a capital lease would be periodically reduced by the total
   a. Minimum lease payment plus the amortization of the related asset.
   b. Minimum lease payment less the amortization of the related asset.
   c. Minimum lease payment less the portion of the minimum lease payment allocable to interest.
   d. Minimum lease payment.

12. Theoretically, the proceeds from the sale of a bond will be equal to
   a. The sum of the face amount of the bond and the periodic interest payments.
   b. The face amount of the bond.
   c. The face amount of the bond plus the present value of the interest payments made during the life of the bond discounted at the prevailing market rate of interest.
   d. The present value of the principal amount due at the end of the life of the bond plus the present value of the interest payments made during the life of the bond, each discounted at the prevailing market rate of interest.

13. When outstanding bonds are converted into common stock, the carrying value of the bonds payable would be removed from the accounts when using the

<table>
<thead>
<tr>
<th>Book value method</th>
<th>Market value method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

14. A portion of the proceeds should be allocated to paid-in capital for bonds issued with

<table>
<thead>
<tr>
<th>Detachable stock purchase warrants</th>
<th>Nondetachable stock purchase warrants</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
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<tr>
<td>b. No</td>
<td>Yes</td>
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<tr>
<td>c. Yes</td>
<td>Yes</td>
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<tr>
<td>d. Yes</td>
<td>No</td>
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</tbody>
</table>

15. A 10-year bond was issued in 1982 at a premium with a call provision to retire the bonds. When the bond issuer exercised the call provision on an interest date in 1985, the call price exceeded the carrying value of the bonds. The amount of bond liability removed from the accounts in 1985 should have equaled the
   a. Cash paid.
   b. Face amount plus unamortized premium.
   c. Call price plus unamortized premium.
   d. Current market price.

16. An activity that would be expensed currently as research and development costs is the
   a. Engineering follow-through in an early phase of commercial production.
   b. Conceptual formulation and design of possible product or process alternatives.
   c. Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity.
   d. Trouble-shooting in connection with breakdowns during commercial production.

17. When the allowance method of recognizing bad debt expense is used, the entries at the time of collection of a small account previously written off would
   a. Decrease the allowance for doubtful accounts.
   b. Increase net income.
   c. Have no effect on the allowance for doubtful accounts.
   d. Have no effect on net income.

18. The pension expense accrued by a company will be increased by interest equivalents when
   a. Amounts funded are greater than pension cost accrued.
   b. Amounts funded are less than pension cost accrued.
   c. The plan is fully vested.
   d. The plan is fully funded.
19. Which of the following contingencies should generally be accrued on the balance sheet when the occurrence of the contingent event is reasonably possible and its amount can be reasonably estimated?

<table>
<thead>
<tr>
<th>Gain contingency</th>
<th>Loss contingency</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

20. Realized gains from the sale of marketable equity securities should be included in net income of the period of sale when the marketable equity securities portfolio of which they are a part is classified as

<table>
<thead>
<tr>
<th>Current</th>
<th>Noncurrent</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
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<tr>
<td>b. Yes</td>
<td>Yes</td>
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<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

21. Gains resulting from the process of translating a foreign entity's financial statements from the functional currency, which has not experienced significant inflation, to U.S. dollars should be included as a

a. Separate component of stockholders' equity.
b. Deferred credit.
c. Component of income from continuing operations.
d. Extraordinary item.

22. The deferred method of tax allocation should be followed for

<table>
<thead>
<tr>
<th>Interperiod income tax allocation</th>
<th>Intrapерiod income tax allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
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<tr>
<td>b. Yes</td>
<td>Yes</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

23. The cumulative effect of a change in accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be reported separately as a component of income after continuing operations for a change from the

a. Double-declining-balance method of depreciation for previously recorded assets to the straight-line method.
b. LIFO method of inventory pricing to the FIFO method.
c. Completed-contract method of accounting for long-term construction-type contracts to the percentage-of-completion method.
d. Percentage-of-completion method of accounting for long-term construction-type contracts to the completed-contract method.

24. A transaction that is unusual in nature and infrequent in occurrence should be reported separately as a component of income

b. Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.
c. After cumulative effect of accounting changes and after 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.

25. In computing earnings per share, a method of recognizing the use of proceeds that would be obtained upon exercise of options and warrants is the

a. Antidilution method.
b. Common stock equivalents method.
c. Treasury stock method.
d. If-converted method.

26. The retirement of long-term debt by the issuance of common stock should be presented in a statement of changes in financial position as a

<table>
<thead>
<tr>
<th>Source of funds</th>
<th>Use of funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
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<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

27. The amortization of bond premium on long-term debt should be presented in a statement of changes in financial position as a

a. Use of funds.
b. Source and a use of funds.
c. Addition to income from continuing operations.
d. Deduction from income from continuing operations.

28. In accounting for a long-term construction contract using the percentage-of-completion method, the progress billings on contracts account is a

a. Contra current asset account.
b. Contra noncurrent asset account.
c. Noncurrent liability account.
d. Revenue account.

29. For an employer's defined benefit pension plan, the actuarial present value of nonvested accumulated plan benefits should be

a. Both an accrual and a disclosure.
b. A disclosure, but not an accrual.
c. An accrual, but not a disclosure.
d. Neither an accrual nor a disclosure.
30. Which of the following should be disclosed in the Summary of Significant Accounting Policies?

<table>
<thead>
<tr>
<th>Basis of consolidation</th>
<th>Composition of plant assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

31. A change in the periods benefitted by a deferred cost because additional information has been obtained is
   a. An accounting change that should be reported in the period of change and future periods if the change affects both.
   b. An accounting change that should be reported by restating the financial statements of all prior periods presented.
   c. A correction of an error.
   d. Not an accounting change.

32. Registration fees related to effecting a business combination should be deducted in determining net income of the combined corporation for the period in which the fees were incurred for a

<table>
<thead>
<tr>
<th>Pooling of interests</th>
<th>Purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
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<tr>
<td>b. No</td>
<td>No</td>
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<tr>
<td>c. Yes</td>
<td>No</td>
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<tr>
<td>d. Yes</td>
<td>Yes</td>
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</tbody>
</table>

33. In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include

<table>
<thead>
<tr>
<th>Expenses related to revenue from intersegment sales</th>
<th>Portion of general corporate expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<tr>
<td>b. Yes</td>
<td>No</td>
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<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
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</table>

34. A development stage enterprise should include with its financial statements certain additional information. Cumulative amounts from the enterprise's inception is an example of additional information that should be included in its

<table>
<thead>
<tr>
<th>Income statement</th>
<th>Statement of changes in financial position</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
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<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

35. How are trade receivables used in the calculation of each of the following?

<table>
<thead>
<tr>
<th>Acid test (quick) ratio</th>
<th>Receivable turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Numerator</td>
<td>Denominator</td>
</tr>
<tr>
<td>c. Denominator</td>
<td>Denominator</td>
</tr>
<tr>
<td>d. Not used</td>
<td>Numerator</td>
</tr>
</tbody>
</table>

36. In developing a factory overhead application rate for use in a process costing system, which of the following could be used in the numerator?
   a. Actual direct labor hours.
   b. Estimated direct labor hours.
   c. Actual factory overhead costs.
   d. Estimated factory overhead costs.

37. The cost of rent for a manufacturing plant is a

<table>
<thead>
<tr>
<th>Prime cost</th>
<th>Product cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
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<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

38. In a job order cost system, the application of factory overhead would usually be reflected in the general ledger as an increase in
   a. Factory overhead control.
   b. Finished goods control.
   c. Work in process control.
   d. Cost of goods sold.

39. Assuming that there was no beginning work in process inventory, and the ending work in process inventory is 50% complete as to conversion costs, the number of equivalent units as to conversion costs would be
   a. The same as the units completed.
   b. The same as the units placed in process.
   c. Less than the units completed.
   d. Less than the units placed in process.

40. Under the three-variance method for analyzing factory overhead, which of the following is used in the computation of the spending variance?

<table>
<thead>
<tr>
<th>Budget allowance based on standard hours</th>
<th>Factory overhead applied to production</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
41. Under the two-variance method for analyzing factory overhead, the difference between the actual factory overhead and the factory overhead applied to production is the
   a. Controllable variance.
   b. Net overhead variance.
   c. Efficiency variance.
   d. Volume variance.

42. Actual sales values at the split-off point for joint products Y and Z are not known. However, 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 for product Z occurs, 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 Product Z.
   b. Decrease for Product Y and increase for Product Z.
   c. Increase for Product Y and decrease for Product Z.
   d. Increase for Product Y and Product Z.

43. The absorption costing method includes in inventory
   \[
   \begin{array}{|c|c|}
   \hline
   \text{Fixed factory overhead} & \text{Variable factory overhead} \\
   \hline
   \text{a. No} & \text{No} \\
   \text{b. No} & \text{Yes} \\
   \text{c. Yes} & \text{Yes} \\
   \text{d. Yes} & \text{No} \\
   \hline
   \end{array}
   \]

44. An internal report for a decentralized organization reports transfers between segments. For this internal report, transfer prices charged for a product with a determinable market price would usually be based on
   a. Cost or market, whichever is lower.
   b. Market price.
   c. Historical cost.
   d. Variable cost.

45. When a flexible budget is used, an increase in production levels within a relevant range would
   a. Not change fixed costs per unit.
   b. Change total fixed costs.
   c. Not change variable costs per unit.
   d. Not change total variable costs.

46. Breakeven analysis assumes over the relevant range that
   a. Total costs are unchanged.
   b. Selling prices are unchanged.
   c. Variable costs are nonlinear.
   d. Fixed costs are nonlinear.

47. The discount rate (hurdle rate of return) must be determined in advance for the
   a. Internal rate of return method.
   b. Net present value method.
   c. Payback period method.
   d. Time adjusted rate of return method.

48. The payback capital budgeting technique considers
   \[
   \begin{array}{|c|c|}
   \hline
   \text{Income over entire life of project} & \text{Time value of money} \\
   \hline
   \text{a. No} & \text{No} \\
   \text{b. No} & \text{Yes} \\
   \text{c. Yes} & \text{Yes} \\
   \text{d. Yes} & \text{No} \\
   \hline
   \end{array}
   \]

49. A company’s return on investment is affected by a change in
   \[
   \begin{array}{|c|c|}
   \hline
   \text{Capital turnover} & \text{Profit margin on sales} \\
   \hline
   \text{a. Yes} & \text{Yes} \\
   \text{b. Yes} & \text{No} \\
   \text{c. No} & \text{No} \\
   \text{d. No} & \text{Yes} \\
   \hline
   \end{array}
   \]

50. In probability analysis, the square root of the mean of the squared differences between the observed values and the expected value is the
   a. Objective function.
   b. Optimum corner point.
   c. EOQ.
   d. Standard deviation.

51. Under which basis of accounting for a governmental unit should revenues be recognized in the accounting period in which they are earned and become measurable?
   \[
   \begin{array}{|c|c|}
   \hline
   \text{Accrual basis} & \text{Modified accrual basis} \\
   \hline
   \text{a. No} & \text{No} \\
   \text{b. No} & \text{Yes} \\
   \text{c. Yes} & \text{Yes} \\
   \text{d. Yes} & \text{No} \\
   \hline
   \end{array}
   \]

52. The estimated revenues control account of a governmental unit is debited when
   a. The budget is closed out at the end of the year.
   b. The budget is recorded.
   c. Actual revenues are recorded.
   d. Actual revenues are collected.

53. When a truck is received by a governmental unit, the truck should be recorded in the general fund as a debit to an
   a. Appropriations control.
   b. Encumbrances control.
   c. Fixed asset.
   d. Expenditures control.
54. Which of the following funds of a governmental unit uses the modified accrual basis of accounting?
   a. Internal service.
   b. Enterprise.
   c. Nonexpendable trust.
   d. Debt service.

55. Proceeds of General Obligation Bonds is an account of a governmental unit that would be included in the
   a. Enterprise fund.
   b. Special assessments fund.
   c. Capital projects fund.
   d. Debt service fund.

56. Which of the following funds of a governmental unit would include contributed capital in its balance sheet?
   a. Expendable pension trust.
   b. Special revenue.
   c. Capital projects.
   d. Internal service.

57. 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 debt service fund.
   b. Liability section of the general long-term debt account group.
   c. Asset section of the debt service fund.
   d. Asset section of the general long-term debt account group.

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

<table>
<thead>
<tr>
<th>Governmental funds</th>
<th>Account groups</th>
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<tbody>
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<td>No</td>
<td>No</td>
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<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

59. A voluntary health and welfare organization received a cash donation in 1983 from a donor specifying that the amount donated be used in 1985. The cash donation should be accounted for as

60. The property, plant, and equipment of a not-for-profit hospital should be accounted for as part of
   a. Unrestricted funds.
   b. Restricted funds.
   c. Specific purpose funds.
   d. Other nonoperating funds.

Number 2 (Estimated time — 15 to 25 minutes)

Gehr Company purchased significant amounts of new equipment this year to be used in its operations. The equipment was delivered by the suppliers, installed by Gehl, and placed into operation. Some of it was purchased for cash with discounts available for prompt payment. Some of it was purchased under long-term payment plans for which the interest charges approximate prevailing rates. As a result, Gehl is studying its capitalization and depreciation policies.

Required:
   a. What costs should Gehl capitalize for the new equipment purchased this year?
   b. What factors cause the equipment to lose its future economic benefit?
   c. What factors should be considered in computing the equipment's depreciation expense?
   d. What theoretical justifications are there for the use of accelerated depreciation methods?

Number 3 (Estimated time — 15 to 25 minutes)

Caddell Company, a wholesaler, purchases its inventories from various suppliers FOB destination; it incurs substantial warehousing costs. Caddell uses the dollar value LIFO inventory cost flow method. Caddell also consigns some of its inventories to Reed Company. Reed also has items for sale that it purchases from other wholesalers. Reed uses the lower of FIFO cost or market inventory method.

Required:
   a. When should the purchases from various suppliers generally be included in Caddell's inventory? Why?
   b. Theoretically, how should Caddell account for the warehousing costs? Why?
   c. 1. What are the advantages of using the dollar value LIFO inventory cost flow method as opposed to the conventional quantity of goods LIFO method?
      2. How does the calculation of dollar value LIFO differ from the conventional quantity of goods method?
   d. How should Caddell account for the inventories consigned to Reed Company? Why?
   e. When Reed applies the lower of cost or market method, what are the ceiling and floor limits?
Number 4 (Estimated time — 15 to 25 minutes)

Walker Company has a noncurrent marketable equity securities portfolio. Walker does not own more than five percent of the outstanding voting stock for any of the securities in the portfolio. At the beginning of the year, the aggregate market value of the portfolio exceeded its cost. Cash dividends on these securities were received during the year. None of the securities in the portfolio were sold during the year. At the end of the year, the aggregate cost of the portfolio exceeded its market value. The decline in the market price of the securities in the portfolio is attributable to general market decline.

During the year, Walker purchased for cash thirty-five percent of the outstanding voting stock of Sipe Company. Cash dividends on this investment were received from Sipe during the year, and the earnings of Sipe after the acquisition date were reported by Sipe to Walker.

Required:

a. How should Walker report on its balance sheet and income statement the effects of its investment in the noncurrent marketable equity securities portfolio for the year? Why?

b. How should Walker report on its balance sheet and income statement the effects of its investment in Sipe for the year? Why?

Number 5 (Estimated time — 15 to 25 minutes)

Brady Company has 30,000 shares of $10 par value common stock authorized and 20,000 shares issued and outstanding. On August 15, 1984, Brady purchased 1,000 shares of treasury stock for $12 per share. Brady uses the cost method to account for treasury stock. On September 14, 1984, Brady sold 500 shares of the treasury stock for $14 per share.

In October 1984, Brady declared and distributed 2,000 shares as a stock dividend from unissued shares when the market value of the common stock was $16 per share.

On December 20, 1984, Brady declared a $1 per share cash dividend, payable on January 10, 1985, to shareholders of record on December 31, 1984.

Required:

a. How should Brady account for the purchase and sale of the treasury stock, and how should the treasury stock be presented in Brady’s balance sheet at December 31, 1984?

b. How should Brady account for the stock dividend, and how would it affect Brady’s stockholders’ equity at December 31, 1984? Why?

c. How should Brady account for the cash dividend, and how would it affect Brady’s balance sheet at December 31, 1984? Why?


ANSWERS TO EXAMINATION

ACCOUNTING THEORY
(Theory of Accounts)
November 8, 1985; 1:30 P.M. to 5:00 P.M.

Answer 1 (60 points)

1. d    11. c    21. a    31. a    41. b    51. d  
2. d    12. d    22. a    32. c    42. c    52. b  
3. b    13. a    23. a    33. b    43. c    53. b  
4. a    14. d    24. a    34. c    44. b    54. d  
5. c    15. b    25. c    35. b    45. c    55. c  
7. d    17. d    27. d    37. a    47. b    57. d  
8. d    18. b    28. a    38. c    48. a    58. b  
10. a   20. b    30. c    40. d    50. d    60. a

The score for the multiple choice question was determined in accordance with the following scale:

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<th>0</th>
<th>1</th>
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</table>
Answer 2 (10 points)

a. The costs that should be capitalized when equipment is purchased for cash should include the gross invoice price of the equipment less discount plus all incidental costs relating to its purchase or preparation for use. Any available discounts whether taken or not should be deducted from the gross invoice price of the equipment.

For equipment purchased under a long-term payment plan, the amount capitalized is the same as for equipment purchased for cash, i.e., the capitalizable cost represents the cash equivalent price. The interest charges should not be capitalized.

b. The physical factors that cause the equipment to depreciate are wear and tear from operation, action of time and other elements, and deterioration and decay. The functional factors that cause the equipment to depreciate are inadequacy, obsolescence, and supersession.

c. The factors that should be considered in computing depreciation expense are the cost of the asset, the estimated residual (salvage) value, and the allocation over the estimated service life of the asset by a systematic and rational allocation procedure.

d. Accelerated depreciation methods are justified based on the following assumptions:

- An asset is more efficient 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.
- Repair expenses on an asset increase in the later years of its estimated useful life. Therefore, smaller depreciation charges in the later years would be combined with the larger repair expenses incurred in the later years resulting in a smooth or level pattern of these expenses.

Answer 3 (10 points)

a. Purchases from various suppliers should generally be included in Caddell’s inventory when Caddell receives the goods. For accounting purposes, in the absence of other information, title to goods purchased FOB destination is assumed to pass when the goods are received.

b. Caddell should account for the warehousing costs as additional cost of inventory. Theoretically, warehousing is a cost of readying the goods for sale and should be included in inventory cost.

e. 1. The advantages of using the dollar value LIFO inventory cost flow method are to reduce the cost of accounting for inventory according to the LIFO method and to minimize the probability of unintentional liquidation of LIFO inventory.

2. The calculation of dollar value LIFO is based on dollars of inventory, a specific price index for each year, and broad inventory pools, whereas the conventional quantity of goods method is applied to individual units of each separate product. The inventory layers are identified with the price index for the year in which the layer was added.

d. Caddell should account for the inventories consigned to Reed Company as part of inventory. Caddell retains title to the goods until their sale by Reed; therefore, the earnings process has not been completed.

e. In applying the lower of cost or market method, market should not exceed the ceiling or fall below the floor. The ceiling is equal to the net realizable value, i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal. The floor is equal to the net realizable value reduced by an allowance for an approximately normal profit margin.
**Answer 4** (10 points)

a. A noncurrent marketable equity securities portfolio should be accounted for at cost or market, whichever is lower. Therefore, at the end of the year Walker should report the noncurrent marketable equity securities portfolio as a noncurrent asset at market. It is conservative to carry the portfolio at market value when it is below cost because of the uncertainty of future recovery of the market decline. The amount by which the aggregate cost of the portfolio exceeded the market value at the end of the year should be accounted for as a valuation allowance to the portfolio. The offsetting portion of the entry is included in the equity section of the balance sheet and shown separately. The rationale for this treatment is that a decline in market value of an equity security classified as a noncurrent asset can be viewed as temporary and thus is not reflected in net income because the probability of realization of the loss is small.

Walker should report the cash dividends received during the year on the securities in the noncurrent marketable equity securities portfolio as dividend income.

b. Due to the size of its investment, i.e., over twenty percent of the outstanding voting stock of Sipe, Walker is presumed to be able to exercise significant influence over Sipe. Therefore, Walker should use the equity method of accounting for its investment in Sipe.

Walker should report the purchase of the stock of Sipe as a long-term investment, and initially account for it at cost, which is the amount of cash paid. The cash dividends received during the year by Walker on the investment in the stock of Sipe should be deducted from the carrying amount of the investment and have no effect on Walker's income statement.

Subsequent to the acquisition, Walker should report thirty-five percent of Sipe's earnings after the acquisition date as revenue in its income statement and add the same amount to the carrying amount of its investment on the balance sheet. This amount should be modified by adjustments similar to those made in preparing consolidated statements, including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between Walker's cost and the underlying equity in net assets of Sipe on the acquisition date.

**Answer 5** (10 points)

a. Brady should account for the purchase of the treasury stock on August 15, 1984, by debiting treasury stock and crediting cash for the cost of the purchase (1,000 shares × $12 per share). Brady should account for the sale of the treasury stock on September 14, 1984, by debiting cash for the selling price (500 shares × $14 per share), crediting treasury stock for cost (500 shares × $12 per share), and crediting additional paid-in capital from treasury stock transactions for the excess of the selling price over the cost (500 shares × $2 per share). The remaining treasury stock (500 shares × $12 per share) should be presented separately in the stockholders' equity section of Brady's December 31, 1984, balance sheet as an unallocated reduction of stockholders' equity. These shares are considered issued but not part of common stock outstanding.

b. Brady should account for the stock dividend by debiting retained earnings for $16 per share (the market value of the stock in October 1984, the date of the stock dividend) multiplied by the 2,000 shares distributed. Brady should then credit common stock for the par value of the common stock ($10 per share) multiplied by the 2,000 shares distributed, and credit additional paid-in capital for the excess of the market value ($16 per share) over the par value ($10 per share) multiplied by the 2,000 shares distributed. Total stockholders' equity does not change, but, because this is considered a small stock dividend, recognition has been made of a capitalization of retained earnings equivalent to the market value of the additional shares resulting from the stock dividend.

c. Brady should account for the cash dividend on December 20, 1984, the declaration date, by debiting retained earnings and crediting cash dividends payable for $1 per share multiplied by the number of shares outstanding. A cash dividend is a distribution to the corporation's stockholders. The liability for this distribution is incurred on the declaration date, and it is a current liability because it is payable within one year (January 10, 1985). The effect of the cash dividend on Brady's balance sheet at December 31, 1984, is an increase in current liabilities and a decrease in retained earnings.
SUGGESTED REFERENCES

Accounting Theory

Number 1

Beams, Advanced Accounting, 2d ed. (Prentice-Hall, 1982).
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Griffin, Williams, and Larson, Advanced Accounting, 4th ed. (Irwin, 1980).
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Welsch, Zlatkovich, and Harrison, Intermediate Accounting, 6th ed. (Irwin, 1982).

Number 2


Number 3


Number 4

AICPA, Accounting Principles Board Opinion no. 18, The Equity Method of Accounting for Investments in Common Stock (AICPA, 1971).

Number 5

AICPA, Accounting Research Bulletin no. 43, Restatement and Revision of Accounting Research Bulletins chap. 7 (AICPA, 1961).
INDEX — QUESTIONS

HOW TO USE THIS INDEX: This index presents examination question number references according to the areas and groups within the Accounting Theory Content Specification Outline. The Appendix located at the back of this book contains the content specification outlines for the four sections of the CPA examination.

The question references listed in the right hand column are designated as follows: The question numbers are followed by the page number (in parentheses) in this book. The letter M following question numbers indicates a multiple choice item. For example, the reference 17M(AP-250) means multiple choice item number 17 on page AP-250; the reference 5(AP-258) means essay or problem number 5 on page AP-258. Note that no distinction has been made between Accounting Practice, Parts I and II.

Accounting Theory — Content Specification Outline

   A. Authority of Pronouncements .........................
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Auditing

Selected Questions
And Unofficial Answers
Indexed To
Content Specification
Outline

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MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Professional Responsibilities

A. General Standards and Rules of Conduct

M85#8. Which of the following is required for a CPA partnership to designate itself “Member of the American Institute of Certified Public Accountants” on its letterhead?
   a. All partners must be members.
   b. The partners whose names appear in the firm name must be members.
   c. At least one of the partners must be a member.
   d. The firm must be a dues paying member.

M85#17. A client company has not paid its 1983 audit fees. According to the AICPA Code of Professional Ethics, for the auditor to be considered independent with respect to the 1984 audit, the 1983 audit fees must be paid before the
   a. 1983 report is issued.
   b. 1984 fieldwork is started.
   c. 1984 report is issued.
   d. 1985 fieldwork is started.

M85#27. Due professional care requires
   a. A critical review of the work done at every level of supervision.
   b. The examination of all corroborating evidence available.
   c. The exercise of error-free judgment.
   d. A study and review of internal accounting control that includes compliance tests.

M85#28. The first general standard requires that the examination of financial statements is to be performed by a person or persons having adequate technical training and
   a. Independence with respect to the financial statements and supplementary disclosures.
   b. Exercising professional care as judged by peer reviewers.
   c. Proficiency as an auditor which likely has been acquired from previous experience.
   d. Objectivity as an auditor as verified by proper supervision.

M85#34. When an accountant is not independent, the accountant is precluded from issuing a
   a. Compilation report.
   b. Review report.
   c. Management advisory report.
   d. Tax planning report.

M85#48. Which one of the following is not a pronouncement of an authoritative body designated by the AICPA Council to establish accounting principles, pursuant to the AICPA Code of Professional Ethics?
   a. AICPA Statements of Position.
   b. AICPA Accounting Principles Board Opinions.
   c. FASB Interpretations.
   d. FASB Statements of Financial Accounting Standards.

N84#1. A CPA, while performing an audit, strives to achieve independence in appearance in order to
   a. Reduce risk and liability.
   b. Comply with the generally accepted standards of field work.
   c. Become independent in fact.
   d. Maintain public confidence in the profession.

N84#2. The AICPA Code of Professional Ethics states that a CPA shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client. This rule should be understood to preclude a CPA from responding to an inquiry made by
   a. An investigative body of a state CPA society.
   b. The trial board of the AICPA.
   c. A CPA-shareholder of the client corporation.
   d. An AICPA voluntary quality review body.

N84#37. Pursuant to the AICPA rules of conduct, if a partner in a two-member partnership dies, the surviving partner may continue to practice as an individual under the existing firm title which includes the deceased partner’s name
   a. For a period of time not to exceed five years.
   b. For a period of time not to exceed two years.
   c. Indefinitely.
   d. Until the partnership pay-out to the deceased partner’s estate is terminated.
N84#46. Inclusion of which of the following in a promotional brochure published by a CPA firm would be most likely to result in a violation of the AICPA rules of conduct?
   a. Reprints of newspaper articles which are laudatory with respect to the firm's expertise.
   b. Services offered and fees for such services, including hourly rates and fixed fees.
   c. Educational and professional attainments of partners.
   d. Testimonials and endorsements.

N84#59. According to the AICPA Code of Professional Ethics, a CPA who has a financial interest in a partnership that invests in a potential client is considered to have
   a. An indirect financial interest in the client.
   b. A direct financial interest in the client.
   c. No financial interest in the client.
   d. A partial financial interest in the client.

M84#1. Adequate technical training and proficiency as an auditor encompasses an ability to understand an EDP system sufficiently to identify and evaluate
   a. The processing and imparting of information.
   b. Essential control features.
   c. All accounting control features.
   d. The degree to which programming conforms with application of generally accepted accounting principles.

M84#51. Which of the following underlies the application of generally accepted auditing standards, particularly the standards of field work and reporting?
   a. The elements of materiality and relative risk.
   b. The element of internal control.
   c. The element of corroborating evidence.
   d. The element of quality control.

M84#54. Which of the following is responsible for the fairness of the representations made in financial statements?
   a. Client's management
   b. Independent auditor
   c. Audit committee
   d. AICPA

N83#8. The application of statistical sampling techniques is least related to which of the following generally accepted auditing standards?
   a. The work is to be adequately planned and assistants, if any, are to be properly supervised.
   b. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
   c. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
   d. 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 examination.

N83#19. Competence as a certified public accountant includes all of the following except
   a. Having the technical qualifications to perform an engagement.
   b. Possessing the ability to supervise and evaluate the quality of staff work.
   c. Warranting the infallibility of the work performed.
   d. Consulting others if additional technical information is needed.

N83#35. Which of the following ultimately determines the specific audit procedures necessary to provide an independent auditor with a reasonable basis for the expression of an opinion?
   a. The audit program.
   b. The auditor's judgment.
   c. Generally accepted auditing standards.
   d. The auditor's working papers.

N83#46. The AICPA Rules of Conduct will ordinarily be considered to have been violated when the CPA represents that specific consulting services will be performed for a stated fee and it is apparent at the time of the representation that the
   a. Actual fee would be substantially higher.
   b. Actual fee would be substantially lower than the fees charged by other CPAs for comparable services.
   c. Fee was a competitive bid.
   d. CPA would not be independent.

N83#55. An auditor is about to commence a recurring annual audit engagement. The continuing auditor's independence would ordinarily be considered to be impaired if the prior year's audit fee
   a. Was only partially paid and the balance is being disputed.
   b. Has not been paid and will not be paid for at least twelve months.
   c. Has not been paid and the client has filed a voluntary petition for bankruptcy.
   d. Was settled by litigation.

N83#56. A CPA's license to practice will ordinarily be suspended or revoked automatically for
   a. Committing an act discreditable to the profession.
   b. Conviction of willful failure to file personal income tax returns.
   c. Refusing to respond to an inquiry by the AICPA practice review committee.
   d. Accepting compensation while honoring a subpoena to appear as an expert witness.
Selected Questions

N82#47. In determining independence with respect to any audit engagement, the ultimate decision as to whether or not the auditor is independent must be made by the

a. Auditor.
b. Client.
c. Audit committee.
d. Public.

N82#48. A CPA certificate is evidence of

a. Recognition of independence.
b. Basic competence at the time the certificate is granted.
c. Culmination of the educational process.
d. Membership in the AICPA.

N82#49. An individual just entering upon an auditing career must obtain professional experience primarily in order to achieve a

a. Positive quality control review.
b. Seasoned judgment.
c. Favorable peer review.
d. Specialty designation by the AICPA.

N82#50. In which of the following instances would the independence of the CPA not be considered to be impaired? The CPA has been retained as the auditor of a brokerage firm

a. Which owes the CPA audit fees for more than one year.
b. In which the CPA has a large active margin account.
c. In which the CPA’s brother is the controller.
d. Which owes the CPA audit fees for current-year services and has just filed a petition for bankruptcy.

N82#51. Pursuant to the AICPA rules of conduct, the auditor’s responsibility to the profession is defined by

a. The AICPA Code of Professional Ethics.
b. Federal laws governing licensed professionals who are involved in interstate commerce.
c. Statements on Auditing Standards.
d. The Bylaws of the AICPA.

N82#52. A CPA who is seeking to sell an accounting practice must

a. Not allow a peer review team to look at working papers and tax returns without permission from the client prior to consummation of the sale.
b. Not allow a prospective purchaser to look at working papers and tax returns without permission from the client.
c. Give all working papers and tax returns to the client.
d. Retain all working papers and tax returns for a period of time sufficient to satisfy the statute of limitations.

M82#33. Mavis, CPA, has audited the financial statements of South Bay Sales Incorporated for several years and had always been paid promptly for services rendered. Last year’s audit invoices have not been paid because South Bay is experiencing cash flow difficulties, and the current year’s audit is scheduled to commence in one week. With respect to the past due audit fees Mavis should

a. Perform the scheduled audit and allow South Bay to pay when the cash flow difficulties are alleviated.
b. Perform the scheduled audit only after arranging a definite payment schedule and securing notes signed by South Bay.
c. Inform South Bay’s management that the past due audit fees are considered an impairment of auditor independence.
d. Inform South Bay’s management that the past due audit fees may be considered a loan on which interest must be imputed for financial statement purposes.

M82#43. In performing an audit, Jackson, CPA, discovers that the professional competence necessary for the engagement is lacking. Jackson informs management of the situation and recommends another local CPA firm, and management engages this other firm. Under these circumstances

a. Jackson may request compensation from the other CPA firm for any professional services rendered to it in connection with the engagement.
b. Jackson may accept a referral fee from the other CPA firm.
c. Jackson has violated the AICPA Code of Professional Ethics because of nonfulfillment of the duty of performance.
d. Jackson’s lack of competence should be construed to be a violation of generally accepted auditing standards.

M82#48. In which of the following instances would the independence of the CPA not be considered to be impaired? The CPA has been retained as the auditor of a

a. Charitable organization in which an employee of the CPA serves as treasurer.
b. Municipality in which the CPA owns $25,000 of the $2,500,000 indebtedness of the municipality.
c. Cooperative apartment house in which the CPA owns an apartment and is not part of the management.
d. Company in which the CPA’s investment club owns a one-tenth interest.

N81#19. A CPA who performs primary actuarial services for a client would normally be precluded from ex-
pressing an opinion on the financial statements of that client if the
a. Fees for the actuarial services have not been paid.
b. Actuarial services are a major determinant of the pension expense.
c. Client is an insurance company.
d. Actuarial assumptions used are not in accordance with generally accepted auditing standards.

M81#43. Inclusion of which of the following statements in a CPA's advertisement is not acceptable pursuant to the AICPA Code of Professional Ethics?
   a. Paul Fall
      Certified Public Accountant
      Fluency in Spanish and French
   b. Paul Fall
      Certified Public Accountant
      J.D., Evans Law School 1964
   c. Paul Fall
      Certified Public Accountant
      Free Consultation
   d. Paul Fall
      Certified Public Accountant
      Endorsed by AICPA

M81#41. Which of the following statements best describes the primary purpose of Statements on Auditing Standards?
   a. They are guides intended to set forth auditing procedures which are applicable to a variety of situations.
   b. They are procedural outlines which are intended to narrow the areas of inconsistency and divergence of auditor opinion.
   c. They are authoritative statements, enforced through the code of professional ethics, and are intended to limit the degree of auditor judgment.
   d. They are interpretations which are intended to clarify the meaning of "generally accepted auditing standards."

M81#48. The third general standard states that due care is to be exercised in the performance of the examination. This standard should be interpreted to mean that a CPA who undertakes an engagement assumes a duty to perform
   a. With reasonable diligence and without fault or error.
   b. As a professional who will assume responsibility for losses consequent upon error of judgment.
   c. To the satisfaction of the client and third parties who may rely upon it.
   d. As a professional possessing the degree of skill commonly possessed by others in the field.

M81#49. Inclusion of which of the following in a promotional brochure published by a CPA firm would be most likely to result in a violation of the AICPA rules of conduct?
   a. Names and addresses, telephone numbers, number of partners, office hours, foreign language competence, and date the firm was established.
   b. Services offered and fees for such services, including hourly rates and fixed fees.
   c. Educational and professional attainments, including date and place of certification, schools attended, dates of graduation, degrees received, and memberships in professional associations.
   d. Names, addresses and telephone numbers of the firm's clients, including the number of years served.

B. Control of the Audit

M85#3. Prior to the acceptance of an audit engagement with a client who has terminated the services of the predecessor auditor, the CPA should
   a. Contact the predecessor auditor without advising the prospective client and request a complete report of the circumstance leading to the termination with the understanding that all information disclosed will be kept confidential.
   b. Accept the engagement without contacting the predecessor auditor since the CPA can include audit procedures to verify the reason given by the client for the termination.
   c. Not communicate with the predecessor auditor because this would in effect be asking the auditor to violate the confidential relationship between auditor and client.
   d. Advise the client of the intention to contact the predecessor auditor and request permission for the contact.

M85#18. A CPA firm's personnel partner periodically studies the CPA firm's personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the CPA firm's adherence to prescribed standards of
   a. Quality control.
   b. Due professional care.
   c. Supervision and review.
   d. Fieldwork

M85#49. Early appointment of the auditor enables preliminary work to be performed by the auditor which benefits the client in that it permits the examination to be performed in
   a. A more efficient manner.
   b. A more thorough manner.
   c. Accordance with quality control standards.
   d. Accordance with generally accepted auditing standards.
Selected Questions

N84#21. Which of the following should an auditor obtain from the predecessor auditor prior to accepting an audit engagement?
   a. Analysis of balance sheet accounts.
   b. Analysis of income statement accounts.
   c. All matters of continuing accounting significance.
   d. Facts that might bear on the integrity of management.

N84#55. Anyone inquiring about the professional reputation and standing of a CPA firm may contact the AICPA Division for CPA Firms and expect to receive
   a. Copies of complaints against the CPA firm that are currently being adjudicated by the AICPA Trial Board.
   b. Copies of peer review reports on the CPA firm after the reports have been accepted by the Division.
   c. Information regarding administrative reprisals that were issued by the Division to individuals within the CPA firm.
   d. Information regarding pending investigations of individuals within the CPA firm.

M84#8. The least important evidence of a CPA firm's evaluation of its system of quality controls would concern the CPA firm's policies and procedures with respect to
   a. Employment (hiring).
   b. Confidentiality of audit engagements.
   c. Assigning personnel to audit engagements.
   d. Determination of audit fees.

M84#33. A difference of opinion concerning accounting and auditing matters relative to a particular phase of the audit arises between an assistant auditor and the auditor responsible for the engagement. After appropriate consultation, the assistant auditor asks to be disassociated from the resolution of the matter. The working papers would probably be
   a. Silent on the matter since it is an internal matter of the auditing firm.
   b. Expanded to note that the assistant auditor is completely disassociated from responsibility for the auditor's opinion.
   c. Expanded to document the additional work required, since all disagreements of this type will require expanded substantive testing.
   d. Expanded to document the assistant auditor's position, and how the difference of opinion was resolved.

N83#40. Which of the following situations would most likely require special audit planning by the auditor?
   a. Some items of factory and office equipment do not bear identification numbers.
   b. Depreciation methods used on the client's tax return differ from those used on the books.
   c. Assets costing less than $500 are expensed even though the expected life exceeds one year.
   d. Inventory is comprised of precious stones.

N83#48. In connection with the element of inspection, a CPA firm's system of quality control should ordinarily provide for the maintenance of
   a. A file of minutes of staff meetings.
   b. Updated personnel files.
   c. Documentation to demonstrate compliance with its policies and procedures.
   d. Documentation to demonstrate compliance with peer review directives.

M83#34. A CPA establishes quality control policies and procedures for deciding whether to accept a new client or continue to perform services for a current client. The primary purpose for establishing such policies and procedures is
   a. To enable the auditor to attest to the integrity or reliability of a client.
   b. To comply with the quality control standards established by regulatory bodies.
   c. To lessen the exposure to litigation resulting from failure to detect irregularities in client financial statements.
   d. To minimize the likelihood of association with clients whose management lacks integrity.

M83#44. In determining estimates of fees, an auditor may take into account each of the following, except the
   a. Value of the service to the client.
   b. Degree of responsibility assumed by undertaking the engagement.
   c. Skills required to perform the service.
   d. Attainment of specific findings.

M83#57. Which of the following is not an element of quality control?
   a. Documentation.
   b. Inspection.
   c. Supervision.
   d. Consultation.

N82#7. What is the responsibility of a successor auditor with respect to communicating with the predecessor auditor in connection with a prospective new audit client?
   a. The successor auditor has no responsibility to contact the predecessor auditor.
   b. The successor auditor should obtain permission from the prospective client to contact the predecessor auditor.
   c. The successor auditor should contact the predecessor regardless of whether the prospective client authorizes contact.
   d. The successor auditor need not contact the predecessor if the successor is aware of all available relevant facts.
Auditing

M82#15. In pursuing a CPA firm's quality control objectives, a CPA firm may maintain records indicating which partners or employees of the CPA firm were previously employed by the CPA firm's clients. Which quality control objective would this be most likely to satisfy?
   a. Professional relationship.
   b. Supervision.
   c. Independence.
   d. Advancement.

M82#4. In an audit situation, communication between successor and predecessor auditors should be
   a. Authorized in an engagement letter.
   b. Acknowledged in a representation letter.
   c. Either written or oral.
   d. Written and included in the working papers.

M82#7. The auditor will not ordinarily initiate discussion with the audit committee concerning the
   a. Extent to which the work of internal auditors will influence the scope of the examination.
   b. Extent to which change in the company's organization will influence the scope of the examination.
   c. Details of potential problems which the auditor believes might cause a qualified opinion.
   d. Details of the procedures which the auditor intends to apply.

M82#34. Within the context of quality control, the primary purpose of continuing professional education and training activities is to enable a CPA firm to provide personnel within the firm with
   a. Technical training that assures proficiency as an auditor.
   b. Professional education that is required in order to perform with due professional care.
   c. Knowledge required to fulfill assigned responsibilities and to progress within the firm.
   d. Knowledge required in order to perform a peer review.

M82#35. With respect to the auditor's planning of a examination, which of the following statements is always true?
   a. An engagement should not be accepted after the fiscal year end.
   b. An inventory count must be observed at the balance sheet date.
   c. The client's audit committee should not be told of the specific audit procedures which will be performed.
   d. It is an acceptable practice to carry out substantial parts of the examination at interim dates.

M82#47. When negotiable securities are of considerable volume, planning by the auditor is necessary to guard against
   a. Unauthorized negotiation of the securities before they are counted.
   b. Unrecorded sales of securities after they are counted.
   c. Substitution of securities already counted for other securities which should be on hand but are not.
   d. Substitution of authentic securities with counterfeit securities.

M82#59. Williams & Co., a large international CPA firm, is to have an "external peer review." The peer review will most likely be performed by
   a. Employees and partners of Williams & Co. who are not associated with the particular audits being reviewed.
   b. Audit review staff of the Securities and Exchange Commission.
   c. Audit review staff of the American Institute of Certified Public Accountants.
   d. Employees and partners of another CPA firm.

M81#13. In planning an audit engagement, which of the following is a factor that affects the independent auditor's judgment as to the quantity, type, and content of working papers?
   a. The estimated occurrence rate of attributes.
   b. The preliminary evaluations based upon initial substantive testing.
   c. The content of the client's representation letter.
   d. The anticipated nature of the auditor's report.

M81#14. Hawkins requested permission to communicate with the predecessor auditor and review certain portions of the predecessor auditor's working papers. The prospective client's refusal to permit this will bear directly on Hawkins's decision concerning the
   a. Adequacy of the preplanned audit program.
   b. Ability to establish consistency in application of accounting principles between years.
   c. Apparent scope limitation.
   d. Integrity of management.

M81#15. Early appointment of the independent auditor will enable
   a. A more thorough examination to be performed.
   b. A proper study and evaluation of internal control to be performed.
   c. Sufficient competent evidential matter to be obtained.
   d. A more efficient examination to be planned.

M81#36. In pursuing its quality control objectives with respect to acceptance of a client, a CPA firm is not likely to
   a. Make inquiries of the proposed client's legal counsel.
   b. Review financial statements of the proposed client.
   c. Make inquiries of previous auditors.
   d. Review the personnel practices of the proposed client.
Selected Questions

M81#58. The independent auditor's plan for an examination in accordance with generally accepted auditing standards is influenced by the possibility of material errors. The auditor will therefore conduct the examination with an attitude of
a. Professional skepticism.
b. Subjective mistrust.
c. Objective indifference.
d. Professional responsiveness.

C. Other Responsibilities

M85#2. When management refuses to disclose illegal activities which were identified by the independent auditor, the independent auditor may be charged with violating the AICPA Code of Professional Ethics for
a. Issuing a disclaimer of opinion.
b. Withdrawing from the engagement.
c. Failure to uncover the illegal activities during prior audits.
d. Reporting these activities to the audit committee.

M85#19. An auditor who believes that a material irregularity may exist should initially
a. Discuss the matter with those believed to be involved in the perpetration of the material irregularity.
b. Discuss the matter with a higher level of management.
c. Withdraw from the engagement.
d. Consult legal counsel.

M85#20. A CPA should not undertake a management advisory service engagement that includes continued participation through implementation, unless
a. Upon implementation a new study and evaluation of the system of internal control is performed.
b. Upon implementation the client's personnel will have the knowledge and ability to adequately maintain and operate such systems as may be involved.
c. The CPA accepts overall responsibility for implementation of the chosen course of action.
d. The CPA acquires an overall knowledge of the client's business that is equivalent to that possessed by management.

M85#43. Where a reasonable basis exists for omission of an answer to an applicable question on a tax return
a. The question may be ignored.
b. A brief explanation of the reason for the omission should be provided.
c. The question should be marked as nonapplicable.
d. A note should be provided which states that the answer will be provided if the information is requested.

M85#50. Even in circumstances where disclosure on a tax return is not required, the CPA may choose to make a disclosure. Such choice may not be made if the intent is to
a. Avoid preparer negligence penalties.
b. Avoid allegations of fraud.
c. Invalidate the preparer's declaration.
d. Disclose a position that might be viewed as contrary to the Internal Revenue Code.

M85#59. In performing MAS engagements, CPAs should not take any positions that might
a. Constitute advice and assistance.
b. Provide technical assistance in implementation.
c. Result in new organizational policies and procedures.
d. Impair their objectivity.

N84#20. Which of the following, if material, would be an irregularity?
 a. Mistakes in the application of accounting principles.
b. Clerical mistakes in the accounting data underlying the financial statements.
c. Misappropriation of an asset or groups of assets.
d. Misinterpretations of facts that existed when the financial statements were prepared.

N84#43. A CPA who is engaged to prepare an income tax return has a duty to prepare it in such a manner that the tax is
a. The legal minimum.
b. Computed in conformity with generally accepted accounting principles.
c. Supported by the client's audited financial statements.
d. Not subject to change upon audit.

N84#45. When unable to determine the amounts associated with certain illegal acts committed by a client, the auditor would most likely issue
a. A review opinion with a separate explanatory paragraph.
b. Only an adverse opinion.
c. Either a qualified opinion or an adverse opinion.
d. Either a qualified opinion or a disclaimer of opinion.

N84#54. The CPA who undertakes the performance of a management advisory service engagement should bear in mind that the results should
a. Increase the client's earnings capabilities.
b. Be communicated in quantitative terms.
c. Not be set forth as quantitative estimates.
d. Not be explicitly or implicitly guaranteed.

M84#40. During the course of an audit, the independent CPA is often called upon to give informal ad-
service on many diverse questions. This type of service differs from management advisory services in that this type of service is informal and therefore

a. The CPA does not make any warranties with respect to the competence of the extemporaneous advice.
b. The CPA is not exposed to liability as a consequence of the extemporaneous advice.
c. No presumption should exist that all pertinent facts have been identified and considered.
d. No presumption should exist that the advice will impact upon the operations of the business enterprise.

N83#11. Pursuant to the AICPA’s statements on responsibilities in tax practice, which of the following is not an acceptable manner of designating that an estimated figure was used in preparing a federal income tax return?

a. Use a round amount.
b. State expressly that an amount has been estimated.
c. Use an amount suggested in a treasury department guideline.
d. Modify the tax preparer’s declaration on the return before signing the tax return.

N83#44. If an illegal act is discovered during the audit of a publicly held company, the auditor should

a. Notify the regulatory authorities.
b. Determine who was responsible for the illegal act.
c. Intensify the examination.
d. Report the act to high level personnel within the client’s organization.

N83#49. A management advisory service consultation, as opposed to a management advisory service engagement, generally involves advice or information given by a CPA that is based upon

a. Existing personal knowledge about the client.
b. An analytical approach and process.
c. Information obtained during an examination of the client’s financial statements.
d. The results of an operational audit.

N83#50. The auditor is most likely to presume that a high risk of a defalcation exists if

a. The client is a multinational company that does business in numerous foreign countries.
b. The client does business with several related parties.
c. Inadequate segregation of duties places an employee in a position to perpetrate and conceal thefts.
d. Inadequate employee training results in lengthy EDP exception reports each month.

N83#53. Jones, CPA, prepared Smith’s 1982 federal income tax return and appropriately signed the preparer’s declaration. Several months later Jones learns that Smith improperly altered several figures before mailing the tax return to the IRS. Jones should communicate disapproval of this action to Smith and

a. Take no further action with respect to the 1982 tax return but consider the implications of Smith’s actions upon any future relationship.
b. Inform the IRS of the unauthorized alteration.
c. File an amended tax return.
d. Refund any fee collected, return all relevant documents, and refuse any further association with Smith.

N83#60. If the auditor considers an illegal act to be sufficiently serious to warrant withdrawing from the engagement, then the auditor should

a. Notify all parties who may rely upon the company’s financial statements of the company’s illegal act.
b. Consult with legal counsel as to what other action, if any, should be taken.
c. Return all incriminating evidence and working papers to the client’s audit committee for follow-up.
d. Contact the successor auditor to make the successor aware of the possible consequences of relying on management’s representations.

M83#8. An auditor who finds that the client has committed an illegal act would be most likely to withdraw from the engagement when the

a. Illegal act affects the auditor’s ability to rely on management representations.
b. Illegal act has material financial statement implications.
c. Illegal act has received widespread publicity.
d. Auditor can reasonably estimate the effect of the illegal act on the financial statements.

M83#48. Generally, the decision to notify parties outside the client’s organization regarding an illegal act is the responsibility of the

a. Independent auditor.
b. Management.
c. Outside legal counsel.
d. Internal auditors.

M82#2. An audit independence issue might be raised by the auditor’s participation in management advisory services engagements. Which of the following statements is most consistent with the profession’s attitude toward this issue?

a. Information obtained as a result of a management advisory services engagement is confidential to that specific engagement and should not influence performance of the attest function.
b. The decision as to loss of independence must be made by the client based upon the facts of the particular case.
c. The auditor should not make management decisions for an audit client.

d. The auditor who is asked to review management decisions is also competent to make these decisions and can do so without loss of independence.

N82#45. Which of the following is implied when a CPA signs the preparer’s declaration on a federal income tax return?

a. The tax return is not misleading based on all information of which the CPA has knowledge.

b. The tax return and supporting schedules were prepared in accordance with generally accepted accounting principles.

c. The tax return was examined in accordance with standards established by the AICPA’s Federal Tax Division.

d. The tax return was prepared by a CPA who maintained an impartial attitude.

N82#53. An auditor has withdrawn from an audit engagement of a publicly-held company after finding irregularities which may materially affect the financial statements. The auditor should set forth the reasons and findings in correspondence to the


b. Client’s legal counsel.

c. Stock exchanges where the company’s stock is traded.

d. Board of directors.

M82#11. The Foreign Corrupt Practices Act requires that

a. Auditors engaged to examine the financial statements of publicly-held companies report all illegal payments to the SEC.

b. Publicly-held companies establish independent audit committees to monitor the effectiveness of their system of internal control.

c. U.S. firms doing business abroad report sizable payments to non-U.S.-citizens to the Justice Department.

d. Publicly-held companies devise and maintain an adequate system of internal accounting control.

N81#18. The audit client’s board of directors and audit committee refused to take any action with respect to an immaterial illegal act which was brought to their attention by the auditor. Because of their failure to act, the auditor withdrew from the engagement. The auditor’s decision to withdraw was primarily due to doubts concerning

a. Inadequate financial statement disclosures.


c. Scope limitations resulting from their inaction.

d. Reliance on management’s representations.

N81#45. Which of the following conditions would not normally cause the auditor to question whether material errors or possible irregularities exist?

a. Bookkeeping errors are listed on an EDP-generated exception report.

b. Differences exist between control accounts and supporting subsidiary records.

c. Transactions are not supported by proper documentation.

d. Differences are disclosed by confirmations.

M81#38. In tax practice, which of the following would not be considered reasonable support for taking a position contrary to the Internal Revenue Code?

a. Proposed regulations advocated by the IRS.

b. Legal opinions as to the constitutionality of a specific provision.

c. Possible conflicts between two sections of the Internal Revenue Code.

d. Tax court decisions not acquiesced to by the IRS.

M81#46. To conceal defalcations involving receivables, the auditor would expect an experienced bookkeeper to charge which of the following accounts?

a. Miscellaneous income.

b. Petty cash.

c. Miscellaneous expense.

d. Sales returns.

M81#55. To establish illegal “slush funds,” corporations may divert cash received in normal business op-
erations. An auditor would encounter the greatest difficulty in detecting the diversion of proceeds from
   a. Scrap sales.
   b. Dividends.
   c. Purchase returns.
   d. C. O. D. sales.

M85#57. Which of the following statements best describes the auditor's responsibility with respect to illegal acts that do not have a material effect on the client's financial statements?
   a. Generally, the auditor is under no obligation to notify parties other than personnel within the client's organization.
   b. Generally, the auditor is under an obligation to see that stockholders are notified.
   c. Generally, the auditor is obligated to disclose the relevant facts in the auditor's report.
   d. Generally, the auditor is expected to compel the client to adhere to requirements of the Foreign Corrupt Practices Act.

II. Internal Control

A. Definitions and Basic Concepts

M85#5. In general, a material internal accounting control weakness may be defined as a condition in which material errors or irregularities may occur and not be detected within a timely period by
   a. An independent auditor during the compliance test phase of the study and evaluation of internal accounting control procedures.
   b. Employees in the normal course of performing their assigned functions.
   c. Management when reviewing interim financial statements and reconciling account balances.
   d. Outside consultants who issue a special-purpose report on internal control.

M85#7. Internal accounting controls are not designed to provide reasonable assurance that
   a. Transactions are executed in accordance with management's authorization.
   b. Irregularities will be eliminated.
   c. Access to assets is permitted only in accordance with management's authorization.
   d. The recorded accountability for assets is compared with the existing assets at reasonable intervals.

M85#10. Which of the following is intended to detect deviations from prescribed Accounting Department procedures?
   a. Substantive tests specified by a standardized audit program.
   b. Compliance tests designed specifically for the client.
   c. Analytical review tests as designed in the industry audit guide.
   d. Computerized analytical tests tailored for the configuration of EDP equipment in use.

M85#22. To provide for the greatest degree of independence in performing internal auditing functions, an internal auditor most likely should report to the
   a. Financial vice-president.
   b. Corporate controller.
   c. Board of directors.
   d. Corporate stockholders.

M85#25. Which of the following activities would most likely be performed in the EDP department?
   a. Initiation of changes to master records.
   b. Conversion of information to machine-readable form.
   c. Correction of transactional errors.
   d. Initiation of changes to existing applications.

M85#26. For control purposes, which of the following should be organizationally segregated from the computer operations function?
   a. Data conversion.
   b. Surveillance of CRT messages.
   c. Systems development.
   d. Minor maintenance according to a schedule.

N84#9. An EDP input control is designed to ensure that
   a. Machine processing is accurate.
   b. Only authorized personnel have access to the computer area.
   c. Data received for processing are properly authorized and converted to machine readable form.
   d. Electronic data processing has been performed as intended for the particular application.

N84#15. The preliminary phase of the auditor's review of internal control is designed to provide infor-
Selected Questions

mation on three matters. Which of the following is not a purpose of the preliminary review?
   a. Determine the extent to which EDP is used in significant accounting applications.
   b. Understand the flow of transactions in the system.
   c. Comprehend the basic structure of accounting control.
   d. Identify the controls on which reliance is planned.

M84#16. When a data base administrator's position exists within a client organization, the auditor must be aware of the
   a. Output effectiveness/efficiency considerations.
   b. Need for coded program files.
   c. Use of encrypted dialog in a two-way authentication process.
   d. Inherent violation of the principle of separation of duties.

M84#13. Which of the following constitutes a weakness in the internal control of an EDP system?
   a. One generation of backup files is stored in an off-premises location.
   b. Machine operators distribute error messages to the control group.
   c. Machine operators do not have access to the complete systems manual.
   d. Machine operators are supervised by the programmer.

M84#14. One of the major problems in an EDP system is that incompatible functions may be performed by the same individual. One compensating control for this is the use of
   a. Echo checks.
   b. A self-checking digit system.
   c. Computer generated hash totals.
   d. A computer log.

M84#24. Totals of amounts in computer-record data fields which are not usually added for other purposes but are used only for data processing control purposes are called
   a. Record totals.
   b. Hash totals.
   c. Processing data totals.
   d. Field totals.

M84#32. When erroneous data are detected by computer program controls, such data may be excluded from processing and printed on an error report. This error report should be reviewed and followed up by the
   a. Computer operator.
   b. Systems analyst.
   c. EDP control group.
   d. Computer programmer.

M84#44. Which of the following is the correct order of performing the auditing procedures A through C below?
   A = Compliance tests.
   B = Preparation of a flowchart depicting the client's system of internal control.
   C = Substantive tests.
   a. ABC
   b. ACB
   c. BAC
   d. BCA

M83#3. The machine language for a specific computer
   a. May be changed by the programmer.
   b. Is the same as all other computer languages.
   c. Is determined by the engineers who designed the computer.
   d. Is always alphabetic.

M83#21. Which of the following is likely to be of least importance to an auditor in reviewing the internal control in a company with automated data processing?
   a. The segregation of duties within the EDP center.
   b. The control over source documents.
   c. The documentation maintained for accounting applications.
   d. The cost/benefit ratio of data processing operations.

M83#52. Which of the following statements regarding auditor documentation of the client's system of internal control is correct?
   a. Documentation must include flow charts.
   b. Documentation must include procedural write-ups.
   c. No documentation is necessary although it is desirable.
   d. No one particular form of documentation is necessary, and the extent of documentation may vary.

M83#16. A secondary objective of the auditor's study and evaluation of internal control is that the study and evaluation provide
   a. A basis for constructive suggestions concerning improvements in internal control.
   b. A basis for reliance on the system of internal accounting control.
   c. An assurance that the records and documents have been maintained in accordance with existing company policies and procedures.
   d. A basis for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
M83#22. In general, a material internal control weakness may be defined as a condition in which material errors or irregularities would ordinarily not be detected within a timely period by

a. An auditor during the normal study and evaluation of the system of internal control.
b. A controller when reconciling accounts in the general ledger.
c. Employees in the normal course of performing their assigned functions.
d. The chief financial officer when reviewing interim financial statements.

M83#35. When an on-line, real-time (OLRT) electronic data processing system is in use, internal control can be strengthened by

a. Providing for the separation of duties between keypunching and error listing operations.
b. Attaching plastic file protection rings to reels of magnetic tape before new data can be entered on the file.
c. Making a validity check of an identification number before a user can obtain access to the computer files.
d. Preparing batch totals to provide assurance that file updates are made for the entire input.

M83#39. Which of the following would not be considered an internal control feature?

a. Use of the double-entry system.
b. An internal audit staff.
c. Competent personnel.
d. A comparison-shopping staff.

M83#59. Proper segregation of functional responsibilities calls for separation of the

a. Authorization, recording, and custodial functions.
b. Authorization, execution, and payment functions.
c. Receiving, shipping, and custodial functions.
d. Authorization, approval, and execution functions.

M83#60. Which of the following is an administrative control?

a. Authorizing credit terms.
b. Execution of transactions.
c. Recording original data.
d. Accountability over source data.

N82#24. When considering internal control, an auditor must be aware of the concept of reasonable assurance which recognizes that the

a. Employment of competent personnel provides assurance that the objectives of internal control will be achieved.
b. Establishment and maintenance of a system of internal control is an important responsibility of the management and not of the auditor.
c. Cost of internal control should not exceed the benefits expected to be derived from internal control.
d. Segregation of incompatible functions is necessary to ascertain that the internal control is effective.

N82#32. One of the major problems in an EDP system is that incompatible functions may be performed by the same individual. One compensating control for this is use of

a. A tape library.
b. A self-checking digit system.
c. Computer generated hash totals.
d. A computer log.

N82#38. Which of the following is not a characteristic of a batch-processed computer system?

a. The collection of like transactions which are sorted and processed sequentially against a master file.
b. Keypunching of transactions, followed by machine processing.
c. The production of numerous printouts.
d. The posting of a transaction, as it occurs, to several files, without intermediate printouts.

N82#50. Which of the following would lessen internal control in an electronic data processing system?

a. The computer librarian maintains custody of computer program instructions and detailed program listings.
b. Computer operators have access to operator instructions and detailed program listings.
c. The control group maintains sole custody of all computer output.
d. Computer programmers write and debug programs which perform routines designed by the systems analyst.

N82#51. An auditor engaged to report on internal accounting control distinguishes between primary control procedures and secondary control procedures. Primary control procedures are designed to achieve one or more specific objectives of a system of internal accounting control. Which of the following would be a primary control procedure?

a. Comparison of receiving reports with vendor invoices prior to payment.
b. Comparison of budgeted costs for direct labor with actual costs for direct labor.
Selected Questions

c. Comparison of actual costs for raw materials with standard costs for raw materials.
d. Comparison of the cost of goods sold with credit sales.

M82#24. The use of fidelity bonds protects a company from embezzlement losses and also
a. Minimizes the possibility of employing persons with dubious records in positions of trust.
b. Reduces the company’s need to obtain expensive business interruption insurance.
c. Allows the company to substitute the fidelity bonds for various parts of internal accounting control.
d. Protects employees who made unintentional errors from possible monetary damages resulting from such errors.

M82#44. Of the following statements about an internal control system, which one is not valid?
a. No one person should be responsible for the custodial responsibility and the recording responsibility for an asset.
b. Transactions must be properly authorized before such transactions are processed.
c. Because of the cost/benefit relationship, a client may apply control procedures on a test basis.
d. Control procedures reasonably insure that collusion among employees can not occur.

M81#6. The computer system most likely to be used by a large savings bank for customers’ accounts would be
a. An on-line, real time system.
b. A batch processing system.
c. A generalized utility system.
d. A direct access data base system.

M81#7. The primary purpose of the auditor’s study and evaluation of internal control is to provide a basis for
a. Determining whether procedures and records that are concerned with the safeguarding of assets are reliable.
b. Constructive suggestions to clients concerning improvements in internal control.
c. Determining the nature, extent, and timing of audit tests to be applied.
d. The expression of an opinion.

M81#8. The purpose of tests of compliance is to provide reasonable assurance that the
a. Accounting treatment of transactions and balances is valid and proper.
b. Accounting control procedures are functioning as intended.
c. Entity has complied with disclosure requirements of generally accepted accounting principles.
d. Entity has complied with requirements of quality control.

M81#20. In the study and review of a client’s EDP internal control system, the auditor will encounter general controls and application controls. Which of the following is an application control?
a. Dual read.
b. Hash total.
c. Systems flowchart.
d. Control over program changes.

M81#34. A procedural control used in the management of a computer center to minimize the possibility of data or program file destruction through operator error includes
a. Control figures.
b. Crossfooting tests.
c. Limit checks.
d. External labels.

M81#35. The use of a header label in conjunction with magnetic tape is most likely to prevent errors by the
a. Computer operator.
b. Keypunch operator.
c. Computer programmer.
d. Maintenance technician.
B. Study and Evaluation of the System

M85#30. Which of the following would be least likely to suggest to an auditor that the client's management may have overridden the internal control system?
   a. There are numerous delays in preparing timely internal financial reports.
   b. Management does not correct internal control weaknesses that it knows about.
   c. Differences are always disclosed on a computer exception report.
   d. There have been two new controllers this year.

M85#41. After the auditor has prepared a flowchart of the internal accounting controls surrounding sales and evaluated the design of the system, the auditor would perform compliance tests on all internal accounting control procedures
   a. Documented in the flowchart.
   b. Considered to be weaknesses that might allow errors to enter the accounting system.
   c. Considered to be strengths that the auditor plans to rely on.
   d. That would aid in preventing irregularities.

M85#51. A client erroneously recorded a large purchase twice. Which of the following internal accounting control measures would be most likely to detect this error in a timely and efficient manner?
   a. Footing the purchases journal.
   b. Reconciling vendors' monthly statements with subsidiary payable ledger accounts.
   c. Tracing totals from the purchases journal to the ledger accounts.
   d. Sending written quarterly confirmations to all vendors.

M85#52. To determine whether the system of internal accounting control operated effectively to minimize errors of failure to invoice a shipment, the auditor would select a sample of transactions from the population represented by the
   a. Customer order file.
   b. Bill of lading file.
   c. Subsidiary customer accounts ledger.
   d. Sales invoice file.

M84#16. Which of the following is not an auditing procedure that is commonly used in performing compliance tests?
   a. Inquiring
   b. Observing
   c. Confirming
   d. Inspecting

M84#25. When reviewing the system of internal control, the auditor would ordinarily prepare and obtain answers to an internal control questionnaire based upon a tentative flowchart of the system. The next step should ordinarily be to
   a. Determine the extent of audit work necessary to form an opinion.
   b. Arrive at a decision regarding the effectiveness of the internal control system.
   c. Gather enough evidence to determine if the internal control system is functioning as described.
   d. Make a preliminary evaluation of the internal control system assuming satisfactory compliance.

M84#41. After the study and evaluation of a client's system of internal accounting control has been completed, an auditor might decide to
   a. Increase the extent of compliance and substantive testing in areas where the system of internal accounting control is strong.
   b. Reduce the extent of compliance testing in areas where the system of internal accounting control is strong.
   c. Reduce the extent of both substantive and compliance testing in areas where the system of internal accounting control is strong.
   d. Increase the extent of substantive testing in areas where the system of internal accounting control is weak.

N83#10. Compliance testing is performed in order to determine whether or not
   a. Controls are functioning as designed.
   b. Necessary controls are absent.
   c. Incompatible functions exist.
   d. Material dollar errors exist.

N83#15. For good internal control, which of the following functions should not be the responsibility of the treasurer's department?
   a. Data processing.
   b. Handling of cash.
   c. Custody of securities.
   d. Establishing credit policies.

N83#27. Auditing by testing the input and output of an EDP system instead of the computer program itself will
   a. Not detect program errors which do not show up in the output sampled.
Selected Questions

b. Detect all program errors, regardless of the nature of the output.
c. Provide the auditor with the same type of evidence.
d. Not provide the auditor with confidence in the results of the auditing procedures.

M83#40. After finishing the review phase of the study and evaluation of internal control in an audit engagement, the auditor should perform compliance tests on
   a. Those controls that the auditor plans to rely upon.
   b. Those controls in which material weaknesses were identified.
   c. Those controls that have a material effect upon the financial statement balances.
   d. A random sample of the controls that were reviewed.

M83#42. Which of the following internal control features would an auditor be least likely to review?
   a. Segregation of the asset-handling and record-keeping functions.
   b. Company policy regarding credit and collection efforts.
   c. Sales and cost records classified by products.
   d. Authorization of additions to plant and equipment.

M83#7. An auditor plans to examine a sample of 20 checks for countersignatures as prescribed by the client's internal control procedures. One of the checks in the chosen sample of 20 cannot be found. The auditor should consider the reasons for this limitation and
   a. Evaluate the results as if the sample size had been 19.
   b. Treat the missing check as a deviation for the purpose of evaluating the sample.
   c. Treat the missing check in the same manner as the majority of the other 19 checks, i.e., countersigned or not.
   d. Choose another check to replace the missing check in the sample.

M83#20. Which of the following would be least likely to be considered an objective of a system of internal control?
   a. Checking the accuracy and reliability of accounting data.
   b. Detecting management fraud.
   c. Encouraging adherence to managerial policies.
   d. Safeguarding assets.

M83#21. After a preliminary review of a client's EDP control, an auditor may decide not to perform compliance tests related to the control procedures within the EDP portion of the client's internal control system. Which of the following would not be a valid reason for choosing to omit compliance tests?
   a. The controls duplicate operative controls existing elsewhere in the system.
   b. There appear to be major weaknesses that would preclude reliance on the stated procedure.
   c. The time and dollar costs of testing exceed the time and dollar savings in substantive testing if the compliance tests show the controls to be operative.
   d. The controls appear adequate enough to be relied upon.

M82#9. The auditor is examining copies of sales invoices only for the initials of the person responsible for checking the extensions. This is an example of a
   a. Compliance test.
   b. Substantive test.
   c. Dual purpose test.
   d. Test of balances.

M82#14. In a study of the system of internal control the completion of a questionnaire is most closely associated with which of the following?
   a. Separation of duties.
   b. Review of the system.
   c. Flowchart accuracy.
   d. Tests of compliance.

M82#27. The reliance placed on substantive tests in relation to the reliance placed on internal control varies in a relationship that is ordinarily
   a. Parallel.
   b. Inverse.
   c. Direct.
   d. Equal.

M82#29. An auditor will ordinarily ascertain whether payroll checks are properly endorsed during the examination of
   a. Time cards.
   b. The voucher system.
   c. Cash in bank.
   d. Accrued payroll.

M82#5. The precision limit for compliance tests necessary to justify reliance on internal accounting control depends primarily on which of the following?
   a. The cause of errors.
   b. The extent of reliance to be placed on the procedures.
   c. The amount of any substantive errors.
   d. The limit used in audits of similar clients.

M82#8. The auditor observes client employees during the review of the system of internal control in order to
   a. Prepare a flowchart.
   b. Update information contained in the organization and procedure manuals.
   c. Corroborate the information obtained during the initial review of the system.
   d. Determine the extent of compliance with quality control standards.
Auditing

M82#13. Which of the following is ordinarily considered a compliance audit procedure?
   a. Send confirmation letters to banks.
   b. Count and list cash on hand.
   c. Examine signatures on checks.
   d. Obtain or prepare reconciliations of bank accounts as of the balance sheet date.

M82#45. The following are steps in the audit process:
   I. Prepare flowchart.
   II. Gather exhibits of all documents.
   III. Interview personnel.

The most logical sequence of steps is
   a. I, II, III.
   b. I, III, II.
   c. III, II, I.
   d. II, I, III.

M82#46. Which of the following sampling methods is most useful to auditors when testing for compliance?
   a. Stratified random sampling.
   b. Attribute sampling.
   c. Variable sampling.
   d. Unrestricted random sampling with replacement.

M82#54. An independent auditor might consider the procedures performed by the internal auditors because
   a. They are employees whose work must be reviewed during substantive testing.
   b. They are employees whose work might be relied upon.
   c. Their work impacts upon the cost/benefit tradeoff in evaluating inherent limitations.
   d. Their degree of independence may be inferred by the nature of their work.

N81#3. A conceptually logical approach to the auditor's evaluation of accounting controls consists of the following four steps:
   I. Determine the accounting control procedures that should prevent or detect errors and irregularities.
   II. Evaluate any weakness to determine its effect on the nature, timing or extent of auditing procedures to be applied and suggestions to be made to the client.
   III. Determine whether the necessary procedures are prescribed and are being followed satisfactorily.
   IV. Consider the types of errors and irregularities that could occur.

What should be the order in which these four steps are performed?
   a. I, II, III, and IV.
   b. I, III, IV, and II.
   c. III, IV, I, and II.
   d. IV, I, III, and II.

N81#6. Which of the following would be inappropriate during a preliminary evaluation of the system of internal control?
   a. Completion of an internal control questionnaire.
   b. Use of attribute sampling.
   c. Oral inquiries.
   d. Review of an accounting manual prepared by the client.

N81#10. Which of the following is likely to be least important to an auditor who is reviewing the internal controls surrounding the automated data processing function?
   a. Ancillary program functions.
   b. Disposition of source documents.
   c. Operator competence.
   d. Bit storage capacity.

N81#16. An internal control questionnaire indicates that an approved receiving report is required to accompany 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 receiving reports and ascertain that the related cancelled checks are dated no earlier than the receiving reports.
   b. Select and examine receiving reports and ascertain that the related cancelled checks are dated no later than the receiving reports.
   c. Select and examine cancelled checks and ascertain that the related receiving reports are dated no earlier than the checks.
   d. Select and examine cancelled checks and ascertain that the related receiving reports are dated no later than the checks.

N81#53. Taylor Sales Corp. maintains a large full-time internal audit staff which reports directly to the chief accountant. Audit reports prepared by the internal auditors indicate that the system is functioning as it should and that the accounting records are reliable. The independent auditor will probably
   a. Eliminate compliance testing.
   b. Increase the depth of the study and evaluation of administrative controls.
   c. Avoid duplicating the work performed by the internal audit staff.
   d. Place limited reliance on the work performed by the internal audit staff.

M81#44. When an independent auditor decides that the work performed by internal auditors may have a bearing on the nature, timing, and extent of contemplated audit procedures, the independent auditor should plan to evaluate the objectivity of the internal auditors. Relative to objectivity, the independent auditor should
   a. Consider the organization level to which internal auditors report the results of their work.
   b. Review the quality control program in effect for the internal audit staff.
Selected Questions

c. Examine the quality of the internal audit reports.
d. Consider the qualifications of the internal audit staff.

M81#50. An auditor's flowchart of a client's internal control system is a diagrammatic representation which depicts the auditor's 
a. Understanding of the system.
b. Program for compliance tests.
c. Documentation of the study and evaluation of the system.
d. Understanding of the types of irregularities which are probable, given the present system.

M81#60. The objective of precision in sampling for compliance testing on an internal control system is to
a. Determine the probability of the auditor's conclusion based upon reliance factors.
b. Determine that financial statements taken as a whole are not materially in error.
c. Estimate the reliability of substantive tests.
d. Estimate the range of procedural deviations in the population.

C. Cycles

M85#9. Which one of the following would the auditor consider to be an incompatible operation if the cashier receives remittances from the mailroom?
   a. The cashier posts the receipts to the accounts receivable subsidiary ledger cards.
   b. The cashier makes the daily deposit at a local bank.
   c. The cashier prepares the daily deposit.
   d. The cashier endorses the checks.

M85#24. Which of the following is an example of a check digit?
   a. An agreement of the total number of employees to the total number of checks printed by the computer.
   b. An algebraically determined number produced by the other digits of the employee number.
   c. A logic test that ensures all employee numbers are nine digits.
   d. A limit check that an employee's hours do not exceed 50 hours per work week.

M85#38. The accounts payable department receives the purchase order form to accomplish all of the following except
   a. Compare invoice price to purchase order price.
   b. Ensure the purchase had been properly authorized.
   c. Ensure the goods had been received by the party requesting the goods.
   d. Compare quantity ordered to quantity purchased.

M85#40. Which of the following internal accounting control procedures could best prevent direct labor from being charged to manufacturing overhead?
   a. Comparison of daily journal entries with factory labor summary.
   b. Examination of routing tickets from finished goods on delivery.
   c. Reconciliation of work in process inventory with cost records.
   d. Recomputation of direct labor based on inspection of time cards.

M85#53. To strengthen internal accounting control over the custody of heavy mobile equipment, the client would most likely institute a policy requiring a periodic
a. Increase in insurance coverage.
   b. Inspection of equipment and reconciliation with accounting records.
   c. Verification of liens, pledges, and collateralizations.
   d. Accounting for work orders.

M85#60. For an appropriate segregation of duties, journalizing and posting summary payroll transactions should be assigned to
   a. The treasurer's department.
   b. General accounting.
   c. Payroll accounting.
   d. The timekeeping department.

N84#10. Carmela Department Stores has a fully integrated EDP accounting system and is planning to issue credit cards to credit-worthy customers. To strengthen internal control by making it difficult for one to create a valid customer account number, the company's independent auditor has suggested the inclusion of a check digit which should be placed
   a. At the beginning of a valid account number, only.
   b. In the middle of a valid account number, only.
   c. At the end of a valid account number, only.
   d. Consistently in any position.

N84#38. To improve accountability for fixed assets retirements, management most likely would implement a system of internal control that includes
   a. Continuous analysis of the repairs and maintenance account.
   b. Periodic inquiry of plant executives by internal auditors as to whether any plant assets have been retired.
   c. Continuous utilization of serially numbered retirement work orders.
   d. Periodic inspection of insurance policies by the internal auditors.
For effective internal control purposes, which of the following individuals should be responsible for mailing signed checks?

- Receptionist.
- Treasurer.
- Accounts payable clerk.
- Payroll clerk.

In updating a computerized accounts receivable file, which one of the following would be used as a batch control to verify the accuracy of posting cash remittances?

- The sum of net sales.
- The sum of cash deposits less discounts taken by customers.
- The sum of cash deposits plus discounts taken by customers.
- The sum of net sales plus discounts taken by customers.

First Federal S & L has an on-line real-time system, with terminals installed in all of its branches. This system will not accept a customer's cash withdrawal instructions in excess of $1,000 without the use of a "terminal audit key." After the transaction is authorized by a supervisor, the bank teller then processes the transaction with the audit key. This control can be strengthened by

- On-line recording of the transaction on an audit override sheet.
- Increasing the dollar amount to $1,500.
- Requiring manual, rather than on-line, recording of all such transactions.
- Using parallel simulation.

The auditor is most likely to seek information from the plant manager with respect to the

- Adequacy of the provision for uncollectible accounts.
- Appropriateness of physical inventory observation procedures.
- Existence of obsolete machinery.
- Deferral of procurement of certain necessary insurance coverage.

In a properly designed internal accounting control system, the same employee should not be permitted to

- Sign checks and cancel supporting documents.
- Receive merchandise and prepare a receiving report.
- Prepare disbursement vouchers and sign checks.
- Initiate a request to order merchandise and approve merchandise received.

The proper use of prenumbered termination notice forms by the payroll department should provide assurance that all

- Uncashed payroll checks were issued to employees who have not been terminated.
- Personnel files are kept up to date.
- Employees who have not been terminated receive their payroll checks.
- Terminated employees are removed from the payroll.

A well functioning system of internal control over the inventory/production functions would provide that finished goods are to be accepted for stock only after presentation of a completed production order and a (an)

- Shipping order.
- Material requisition.
- Bill of lading.
- Inspection report.

Hitex, Inc., has changed from a conventional to a computerized payroll clock card system. Factory employees now record time in and out with magnetic cards and the EDP system automatically updates all payroll records. Because of this change

- The auditor must audit through the computer.
- Internal control has improved.
- Part of the audit trail has been lost.
- The potential for payroll related fraud has been diminished.

From the auditor's point of view, inventory counts are more acceptable prior to the year end when

- Internal control is weak.
- Accurate perpetual inventory records are maintained.
- Inventory is slow-moving.
- Significant amounts of inventory are held on a consignment basis.

In the weekly computer run to prepare payroll checks, a check was printed for an employee who had been terminated the previous week. Which of the following controls, if properly utilized, would have been most effective in preventing the error or ensuring its prompt detection?

- A control total for hours worked, prepared from time cards collected by the timekeeping department.
- Requiring the treasurer's office to account for the numbers of the prenumbered checks issued to the EDP department for the processing of the payroll.
- Use of a check digit for employee numbers.
- Use of a header label for the payroll input sheet.

The least crucial element of internal control over cash is

- Separation of cash record-keeping from custody of cash.
- Preparation of the monthly bank reconciliation.
- Batch processing of checks.
- Separation of cash receipts from cash disbursements.
M83#15. Which of the following is not a universal rule for achieving strong internal control over cash?
   a. Separate the cash-handling and record-keeping functions.
   b. Decentralize the receiving of cash as much as possible.
   c. Deposit each day’s cash receipts by the end of the day.
   d. Have bank reconciliations performed by employees independent with respect to handling cash.

M83#23. Which of the following sets of duties would ordinarily be considered basically incompatible in terms of good internal control?
   a. Preparation of monthly statements to customers and maintenance of the accounts receivable subsidiary ledger.
   b. Posting to the general ledger and approval of additions and terminations relating to the payroll.
   c. Custody of unmailed signed checks and maintenance of expense subsidiary ledgers.
   d. Collection of receipts on account and maintaining accounts receivable records.

M83#41. In connection with the examination of financial statements by an independent auditor, the client suggests that members of the internal audit staff be utilized to minimize audit costs. Which of the following tasks could most appropriately be delegated to the internal audit staff?
   a. Selection of accounts receivable for confirmation, based upon the internal auditor’s judgment as to how many accounts and which accounts will provide sufficient coverage.
   b. Preparation of schedules for negative accounts receivable responses.
   c. Evaluation of the internal control for accounts receivable and sales.
   d. Determination of the adequacy of the allowance for doubtful accounts.

M83#47. 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. Net pay.
   b. Department numbers.
   c. Hours worked.
   d. Total debits and total credits.

M82#3. At which point in an ordinary sales transaction of a wholesaling business would a lack of specific authorization be of least concern to the auditor in the conduct of an audit?
   a. Granting of credit.
   b. Shipment of goods.
   c. Determination of discounts.
   d. Selling of goods for cash.

M82#19. When a customer fails to include a remittance advice with a payment, it is a common practice for the person opening the mail to prepare one. Consequently, mail should be opened by which of the following four company employees?
   a. Credit manager.
   b. Receptionist.
   c. Sales manager.
   d. Accounts receivable clerk.

M82#30. A company holds bearer bonds as a short-term investment. Responsibility for custody of these bonds and submission of coupons for periodic interest collections probably should be delegated to the
   a. Chief Accountant.
   b. Internal Auditor.
   c. Cashier.
   d. Treasurer.

M62#18. Budd, the purchasing agent of Lake Hardware Wholesalers, has a relative who owns a retail hardware store. Budd arranged for hardware to be delivered by manufacturers to the retail store on a C.O.D. basis, thereby enabling his relative to buy at Lake’s wholesale prices. Budd was probably able to accomplish this because of Lake’s poor internal control over
   a. Purchase requisitions.
   b. Cash receipts.
   c. Perpetual inventory records.
   d. Purchase orders.

M62#32. To minimize the opportunities for fraud, unclaimed cash payroll should be
   a. Deposited in a safe deposit box.
   b. Held by the payroll custodian.
   c. Deposited in a special bank account.
   d. Held by the controller.

M82#51. For effective internal control, the billing function should be performed by the
   a. Accounting department.
   b. Sales department.
   c. Shipping department.
   d. Credit and collection department.

M62#55. A large retail enterprise has established a policy which requires that the paymaster deliver all unclaimed payroll checks to the internal auditing department at the end of each payroll distribution day. This policy was most likely adopted in order to
   a. Assure that employees who were absent on a payroll distribution day are not paid for that day.
   b. Prevent the paymaster from cashing checks which are unclaimed for several weeks.
   c. Prevent a bona fide employee’s check from being claimed by another employee.
   d. Detect any fictitious employee who may have been placed on the payroll.
M82#57. Apex Manufacturing Corporation mass produces eight different products. The controller who is interested in strengthening internal controls over the accounting for materials used in production would be most likely to implement
   a. An economic order quantity (EOQ) system.
   b. A job order cost accounting system.
   c. A perpetual inventory system.
   d. A separation of duties among production personnel.

M81#39. For several years a client’s physical inventory count has been lower than what was shown on the books at the time of the count so that downward adjustments to the inventory account were required. Contributing to the inventory problem could be weaknesses in internal control that led to the failure to record some
   a. Purchases returned to vendors.
   b. Sales returns received.
   c. Sales discounts allowed.
   d. Cash purchases.

M81#9. A sales cutoff test of billings complements the verification of
   a. Sales returns.
   b. Cash
   c. Accounts receivable.
   d. Sales allowances.

M81#51. In the audit of which of the following types of profit-oriented enterprises would the auditor be most likely to place special emphasis on testing the internal controls over proper classification of payroll transactions?
   a. A manufacturing organization.
   b. A retailing organization.
   c. A wholesaling organization.
   d. A service organization.

M81#59. When evaluating inventory controls with respect to segregation of duties, a CPA would be least likely to
   a. Inspect documents.
   b. Make inquiries.
   c. Observe procedures.
   d. Consider policy and procedure manuals.

D. Other Considerations

M85#21. A study and evaluation of internal accounting control made in connection with an annual audit is usually not sufficient to express an opinion on an entity’s internal accounting control because
   a. Weaknesses in the system may go unnoticed during the audit engagement.
   b. A study and evaluation of internal control is not necessarily made during an audit engagement.
   c. Only those controls on which an auditor intends to rely are reviewed, tested, and evaluated.
   d. Internal accounting controls can change each year.

M85#23. An underlying feature of random-based selection of items is that each
   a. Stratum of the accounting population be given equal representation in the sample.
   b. Item in the accounting population be randomly ordered.
   c. Item in the accounting population should have an opportunity to be selected.
   d. Item must be systematically selected using replacement.

M85#35. In performing compliance testing, the auditor will normally find that
   a. The level of risk is directly proportionate to the rate of error.
   b. The rate of deviations in the sample exceeds the rate of error in the accounting records.
   c. The rate of error in the sample exceeds the rate of deviations.
   d. All unexamined items result in errors in the accounting records.

M85#54. During the audit the independent auditor identified the existence of a material weakness in the client’s system of internal accounting controls and orally communicated this finding to the client’s senior management and audit committee. The auditor should
   a. Consider the material weakness a scope limitation and therefore disclaim an opinion.
   b. Document the matter in the working papers and consider the effects of the weakness on the audit.
   c. Suspend all audit activities pending directions from the client’s audit committee.
   d. Withdraw from the engagement.

N84#32. In assessing sampling risk, the risk of incorrect rejection and the risk of underreliance on internal accounting control relate to the
   a. Efficiency of the audit.
   b. Effectiveness of the audit.
   c. Selection of the sample.
   d. Audit quality controls.

N84#39. An auditor’s report on internal control of a publicly held company would ordinarily be of least use to
   a. Shareholders.
   b. Officers.
   c. Directors.
   d. Regulatory agencies.
Selected Questions

N83#7. Which of the following is an element of sampling risk?
   a. Choosing an audit procedure that is inconsistent with the audit objective.
   b. Choosing a sample size that is too small to achieve the sampling objective.
   c. Failing to detect an error on a document that has been inspected by the auditor.
   d. Failing to perform audit procedures that are required by the sampling plan.

N83#12. If the achieved precision range of a statistical sample at a given reliability level is greater than the desired range, this is an indication that the
   a. Standard deviation was larger than expected.
   b. Standard deviation was less than expected.
   c. Population was larger than expected.
   d. Population was smaller than expected.

N83#32. An auditor examining inventory may appropriately apply sampling for attributes in order to estimate the
   a. Average price of inventory items.
   b. Percentage of slow-moving inventory items.
   c. Dollar value of inventory.
   d. Physical quantity of inventory items.

N83#34. A CPA's study and evaluation of the system of internal accounting control in an audit
   a. Is generally more limited than that made in connection with an engagement to express an opinion on the system of internal accounting control.
   b. Is generally more extensive than that made in connection with an engagement to express an opinion on the system of internal accounting control.
   c. Will generally be identical to that made in connection with an engagement to express an opinion on the system of internal accounting control.
   d. Will generally result in the CPA expressing an opinion on the system of internal accounting control.

N84#10. At times a sample may indicate that the auditor's planned degree of reliance on a given control is reasonable when, in fact, the true compliance rate does not justify such reliance. This situation illustrates the risk of
   a. Overreliance.
   b. Underreliance.
   c. Incorrect precision.
   d. Incorrect rejection.

M84#20. The accountant's report expressing an opinion on an entity's system of internal accounting control should state that the
   a. Establishment and maintenance of the system of internal control are the responsibility of management.
   b. Objectives of the client's system of internal accounting control are being met.
   c. Study and evaluation of the system of internal control was conducted in accordance with generally accepted auditing standards.
   d. Inherent limitations of the client's system of internal accounting control were examined.

M84#37. The accountant's report expressing an opinion on an entity's system of internal accounting control would not include:
   a. Description of the scope of the engagement.
   b. Specific date that the report covers, rather than a period of time.
   c. Brief explanation of the broad objectives and inherent limitations of internal accounting control.
   d. Statement that the entity's system of internal accounting control is consistent with that of the prior year after giving effect to subsequent changes.

N84#57. Given random selection, the same sample size, and the same precision requirement for the testing of two unequal populations, the risk of overreliance on the smaller population is
   a. The same as the risk of overreliance on the larger population.
   b. Higher than the risk of overreliance on the larger population.
   c. Lower than the risk of overreliance on the larger population.
   d. Indeterminable relative to the risk of overreliance on the larger population.

M84#3. The tolerable rate of deviations for a compliance test is generally
   a. Lower than the expected rate of errors in the related accounting records.
   b. Higher than the expected rate of errors in the related accounting records.
   c. Identical to the expected rate of errors in the related accounting records.
   d. Unrelated to the expected rate of errors in the related accounting records.

N83#5. If the auditor is concerned that a population may contain exceptions, the determination of a sample size sufficient to include at least one such exception is a characteristic of
   a. Discovery sampling.
   b. Variables sampling.
   c. Random sampling.
   d. Dollar-unit sampling.
M83#54. Which of the following best illustrates the concept of sampling risk?
   a. A randomly chosen sample may not be representative of the population as a whole on the characteristic of interest.
   b. An auditor may select audit procedures that are not appropriate to achieve the specific objective.
   c. An auditor may fail to recognize errors in the documents examined for the chosen sample.
   d. The documents related to the chosen sample may not be available for inspection.

M83#54. Which of the following symbolic representations indicate that a file has been consulted?
   a. 
   b. 
   c. 
   d. 

M82#42. The auditor who becomes aware of a material weakness in internal control is required to communicate this to the
   a. Audit committee and client's legal counsel.
   b. Board of directors and internal auditors.
   c. Senior management and board of directors.
   d. Internal auditors and senior management.

M82#42. An auditor's report on internal accounting control is least likely to be issued as a result of a (an)
   a. Audit of the financial statements of a governmental agency.
   b. Review of the annual financial statements of a large corporation.
   c. Special study of a proposed system of internal accounting control.
   d. Special study of related party transactions.

N81#7. If the size of the sample to be used in a particular test of attributes has not been determined by utilizing statistical concepts, but the sample has been chosen in accordance with random selection procedures,
   a. No inferences can be drawn from the sample.
   b. The auditor has committed a nonsampling error.
   c. The auditor may or may not achieve desired precision at the desired level of confidence.
   d. The auditor will have to evaluate the results by reference to the principles of discovery sampling.

N81#29. When performing a compliance test with respect to control over cash disbursements, a CPA may use a systematic sampling technique with a start at any randomly selected item. The biggest disadvantage of this type of sampling is that the items in the population
   a. Must be recorded in a systematic pattern before the sample can be drawn.
   b. May occur in a systematic pattern, thus destroying the sample randomness.
   c. May systematically occur more than once in the sample.
   d. Must be systematically replaced in the population after sampling.
Selected Questions

M81#50. Which of the following reports is an indication of the changing role of the CPA that calls for an extension of the auditor’s attest function?
   b. Report on internal control based on an audit.
   d. Report on balance sheet and statements of income, retained earnings, and changes in financial position prepared from incomplete financial records.

M81#55. Which of the following statements with respect to required auditor communication of weaknesses in internal accounting controls is correct?
   a. Such communication is required to be in writing.
   b. Such communication must include a description of all weaknesses.
   c. Such communication is the principal reason for testing and evaluating internal controls.
   d. Such communication is incidental to the auditor’s study and evaluation of the system of internal accounting control.

M81#22. During the review of an EDP internal control system an auditor may review decision tables prepared by the client. A decision table is usually prepared by a client to supplement or replace the preparation of
   a. An internal control questionnaire when the number of alternative responses is large.
   b. A narrative description of a system where transactions are not processed in batches.
   c. Flowcharts when the number of alternatives is large.
   d. An internal control questionnaire not specifically designed for an EDP installation.

III. Evidence and Procedures

A. Audit Evidence

M85#13. An auditor accepted an engagement to audit the 1984 financial statements of EFG Corporation and began the field work on September 30, 1984. EFG gave the auditor the 1984 financial statements on January 17, 1985. The auditor completed the field work on February 10, 1985 and delivered the report on February 16, 1985. The client’s representation letter normally would be dated

M85#46. 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 work to be performed by the specialist. Preferably, the understanding should be documented and would include all of the following, except
   a. The objectives and scope of the specialist’s work.
   b. The specialist’s representations as to his relationship, if any, to the client.
   c. The specialist’s understanding of the auditor’s corroborative use of the specialist’s findings in relation to the representations in the financial statements.
   d. A statement that the methods or assumptions to be used are not inconsistent with those used by the client.

M85#47. When perpetual inventory records are maintained in quantities and in dollars, and internal accounting control over inventory is weak, the auditor would probably
   a. Want the client to schedule the physical inventory count at the end of the year.
   b. Insist that the client perform physical counts of inventory items several times during the year.
   c. Increase the extent of tests for unrecorded liabilities at the end of the year.
   d. Have to disclaim an opinion on the income statement for that year.

M85#56. Which of the following statements regarding the audit of negotiable notes receivable is not correct?
   a. Confirmation from the debtor is an acceptable alternative to inspection.
   b. Materiality of the amount involved is a factor considered when selecting the accounts to be confirmed.
   c. Physical inspection of a note by the auditor does not provide conclusive evidence.
   d. Notes receivable discounted with recourse need to be confirmed.

M85#58. The audit inquiry letter to the client’s legal counsel should be mailed only by the
   a. Client after the auditor has reviewed it for appropriate content.
   b. Auditor after preparation by the client and review by the auditor.
   c. Auditor’s attorney after preparation by the client and review by the auditor.
   d. Client after review by the auditor’s attorney.
**Auditing**

**N84#17.** A written representation from a client’s management which, among other matters, acknowledges responsibility for the fair presentation of financial statements, should normally be signed by the

a. Chief executive officer and the chief financial officer.
b. Chief financial officer and the chairman of the board of directors.
c. Chairman of the audit committee of the board of directors.
d. Chief executive officer, the chairman of the board of directors, and the client’s lawyer.

**N84#18.** To ascertain the exact name of the corporate client, the auditor relies primarily on

a. Corporate minutes.
b. Bylaws.
c. Articles of incorporation.
d. Tax returns.

**N84#24.** An auditor should perform alternative procedures to substantiate the existence of accounts receivable when

a. No reply to a positive confirmation request is received.
b. No reply to a negative confirmation request is received.
c. Collectibility of the receivables is in doubt.
d. Pledging of the receivables is probable.

**N84#26.** Which of the following ratios would be the least useful in reviewing the overall profitability of a manufacturing company?

a. Net income to net worth.
b. Net income to working capital.
c. Net income to sales.
d. Net income to total assets.

**N84#33.** In a manufacturing company, which one of the following audit procedures would give the least assurance of the valuation of inventory at the audit date?

a. Testing the computation of standard overhead rates.
b. Examining paid vendors’ invoices.
c. Reviewing direct labor rates.
d. Obtaining confirmation of inventories pledged under loan agreements.

**N84#35.** Which of the following would be least likely to be comparable between similar corporations in the same industry line of business?

a. Earnings per share.
b. Return on total assets before interest and taxes.
c. Accounts receivable turnover.
d. Operating cycle.

**N84#40.** The auditor can best verify a client’s bond sinking fund transactions and year-end balance by

a. Confirmation with individual holders of retired bonds.
b. Confirmation with the bond trustee.

c. Recomputation of interest expense, interest payable, and amortization of bond discount or premium.
d. Examination and count of the bonds retired during the year.

**N84#55.** If a lawyer refuses to furnish corroborating information regarding litigation, claims, and assessments, the auditor should

a. Honor the confidentiality of the client-lawyer relationship.
b. Consider the refusal to be tantamount to a scope limitation.
c. Seek to obtain the corroborating information from management.
d. Disclose this fact in a footnote to the financial statements.

**M84#2.** The auditor faces a risk that the examination will not detect material errors in the financial statements. In regard to minimizing this risk, the auditor primarily relies on

a. Substantive tests.
b. Compliance tests.
c. Internal control.
d. Statistical analysis.

**M84#6.** In the confirmation of accounts receivable the auditor would most likely

a. Request confirmation of a sample of the inactive accounts.
b. Seek to obtain positive confirmations for at least 50% of the total dollar amount of the receivables.
c. Require confirmation of all receivables from agencies of the federal government.
d. Require that confirmation requests be sent within one month of the fiscal year-end.

**M84#11.** Which of the following expressions is least likely to be included in a client’s representation letter?

a. No events have occurred subsequent to the balance sheet date that require adjustment to, or disclosure in, the financial statements.
b. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
c. Management acknowledges responsibility for illegal actions committed by employees.
d. Management has made available all financial statements and related data.

**M84#19.** Auditors may use positive and/or negative forms of confirmation requests for accounts receivable. An auditor most likely will use

a. The positive form to confirm all balances regardless of size.
b. A combination of the two forms, with the positive form used for large balances and the negative form for the small balances.
Selected Questions

c. A combination of the two forms, with the
positive form used for trade receivables and
the negative form for other receivables.
d. The positive form when controls related to
receivables are satisfactory, and the negative
form when controls related to receivables are
unsatisfactory.

M84#22. An auditor should obtain written representa-
tions from management concerning litigation claims
and assessments. These representations may be limited
to matters that are considered either individually or
collectively material, provided an understanding on the
limits of materiality for this purpose has been reached by
a. The auditor and the client’s lawyer.
b. Management and the auditor.
c. Management, the client’s lawyer, and the au-
ditor.
d. The auditor independently of management.

M84#23. Of the following which is the least persuasive
type of audit evidence?
a. Documents mailed by outsiders to the aud-
tor.
b. Correspondence between auditor and ven-
dors.
c. Copies of sales invoices inspected by the au-
ditor.
d. Computations made by the auditor.

M84#26. As a result of analytical review procedures,
the independent auditor determines that the gross profit
percentage has declined from 30% in the preceding year
to 20% in the current year. The auditor should
a. Document management’s intentions with re-
spect to plans for reversing this trend.
b. Evaluate management’s performance in caus-
ing this decline.
c. Require footnote disclosure.
d. Consider the possibility of an error in the fi-
nancial statements.

M84#27. The auditor notices significant fluctuations
in key elements of the company’s financial statements.
If management is unable to provide an acceptable ex-
planation, the auditor should
a. Consider the matter a scope limitation.
b. Perform additional audit procedures to in-
vestigate the matter further.
c. Intensify the examination with the expecta-
tion of detecting management fraud.
d. Withdraw from the engagement.

M84#29. Analytical review procedures are
a. Substantive tests designed to evaluate a sys-
tem of internal control.
b. Compliance tests designed to evaluate the
validity of management’s representation letter.

c. Substantive tests designed to evaluate the rea-
sonableness of financial information.
d. Compliance tests designed to evaluate the
reasonableness of financial information.

M84#31. The auditor may refer to and identify a spe-
cialist in the auditor’s report if the auditor
a. Expresses an unqualified opinion.
b. Believes it will facilitate an understanding of
the reason for modification of the report.
c. Wishes to indicate a division of responsibility.
d. Wishes to emphasize the thoroughness of the
audit.

M84#35. Which of the following is not a specialist
upon whose work an auditor may rely?
a. Actuary
b. Appraiser
c. Internal auditor
d. Engineer

M84#36. Of the following, which is the most efficient
audit procedure for verification of interest earned on
bond investments?
a. Tracing interest declarations to an indepen-
dent record book.
b. Recomputing interest earned.
c. Conforming interest rate with the issuer of
the bonds.
d. Vouching the receipt and deposit of interest
checks.

M84#50. Refusal by the client’s legal counsel to fur-
nish certain requested information would most likely
be considered
a. A limitation in the scope of the auditor’s ex-
amination.
b. Indicative of the existence of material unas-
serted loss contingencies.
c. A characteristic of untrustworthy manage-
ment.
d. Evidence of an inability to formulate an op-
inion regarding the outcome of pending litiga-
tion.

M84#80. The letter of inquiry that is ordinarily sent
to lawyers with whom management consulted concern-
ing litigation, claims, and assessments is the auditor’s
method of
a. Identifying all possible unasserted claims.
b. Obtaining admissions of irregularities which
are safeguarded by privileged communications
laws.
c. Obtaining corroboration of information fur-
nished by the client.
d. Identifying impaired assets and incurred lia-
Bilities.
N83#2. Which of the following is not a typical analytical review procedure?
   a. Study of relationships of financial information with relevant nonfinancial information.
   b. Comparison of financial information with similar information regarding the industry in which the entity operates.
   c. Comparison of recorded amounts of major disbursements with appropriate invoices.
   d. Comparison of recorded amounts of major disbursements with budgeted amounts.

c. One of the EDP control clerks has been removing all sales invoices applicable to his account from the data file.
d. The credit manager has misappropriated remittances from customers whose accounts have been written off.

N83#25. During the process of confirming receivables as of December 31, 1982, a positive confirmation was returned indicating the “balance owed as of December 31 was paid on January 9, 1983.” The auditor would most likely
   a. Determine whether there were any changes in the account between January 1 and January 9, 1983.
   b. Determine whether a customary trade discount was taken by the customer.
   c. Reconfirm the zero balance as of January 10, 1983.
   d. Verify that the amount was received.

N83#28. Apex Incorporated issued common stock to acquire another company, in an acquisition that was accounted for as a pooling of interests. The auditor examining this transaction would be least interested in ascertaining
   a. The net book value of the acquired company.
   b. The par value of the stock that was issued.
   c. Whether or not the acquisition was approved by the board of directors of Apex Incorporated.
   d. Whether the fair market value of the acquired assets were independently appraised.

N83#35. Which of the following best describes how the detailed audit program of the 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 more detailed and covers areas that would normally not be reviewed by the CPA.
   b. The comprehensive internal audit program is more detailed although it covers less areas than would normally be covered by the CPA.
   c. The comprehensive internal audit program is substantially identical to the audit program used by the CPA because both review substantially identical areas.
   d. The comprehensive internal audit program is less detailed and covers less areas than would normally be reviewed by the CPA.

N83#45. In the examination of property, plant, and equipment, the auditor tries to determine all of the following except the
   a. Adequacy of internal control.
   b. Extent of property abandoned during the year.
   c. Adequacy of replacement funds.
   d. Reasonableness of the depreciation.
**Selected Questions**

**M83#47.** Which of the following best describes the primary purpose of audit procedures?
   a. To detect errors or irregularities.
   b. To comply with generally accepted accounting principles.
   c. To gather corroborative evidence.
   d. To verify the accuracy of account balances.

**M83#51.** An auditor will ordinarily examine invoices from lawyers primarily in order to
   a. Substantiate accruals.
   b. Assess the legal ramifications of litigation in progress.
   c. Estimate the dollar amount of contingent liabilities.
   d. Identify possible unasserted litigation, claims, and assessments.

**M83#3.** The procedures specifically outlined in an audit program are primarily designed to
   a. Protect the auditor in the event of litigation.
   b. Detect errors or irregularities.
   c. Test internal systems.
   d. Gather evidence.

**M83#19.** Each of the following might, in itself, form a valid basis for an auditor to decide to omit a test except the
   a. Relative risk involved.
   b. Relationship between the cost of obtaining evidence and its usefulness.
   c. Difficulty and expense involved in testing a particular item.
   d. Degree of reliance on the relevant internal controls.

**M83#32.** An auditor reconciles the total of the accounts receivable subsidiary ledger to the general ledger control account, as of October 31, 1982. By this procedure, the auditor would be most likely to learn of which of the following?
   a. An October invoice was improperly computed.
   b. An October check from a customer was posted in error to the account of another customer with a similar name.
   c. An opening balance in a subsidiary ledger account was improperly carried forward from the previous accounting period.
   d. An account balance is past due and should be written off.

**M83#33.** An auditor has accounted for a sequence of inventory tags and is now going to trace information on a representative number of tags to the physical inventory sheets. The purpose of this procedure is to obtain assurance that
   a. The final inventory is valued at cost.
   b. All inventory represented by an inventory tag is listed on the inventory sheets.
   c. All inventory represented by an inventory tag is bona fide.
   d. Inventory sheets do not include untagged inventory items.

**M83#36.** The physical count of inventory of a retailer was higher than shown by the perpetual records. Which of the following could explain the difference?
   a. Inventory items had been counted but the tags placed on the items had not been taken off the items and added to the inventory accumulation sheets.
   b. Credit memos for several items returned by customers had not been recorded.
   c. No journal entry had been made on the retailer's books for several items returned to its suppliers.
   d. An item purchased "FOB shipping point" had not arrived at the date of the inventory count and had not been reflected in the perpetual records.

**M83#39.** Which of the following auditing procedures is ordinarily performed last?
   a. Reading of the minutes of the directors’ meetings.
   b. Confirming accounts payable.
   c. Obtaining a management representation letter.
   d. Testing of the purchasing function.

**M83#46.** Which of the following is ordinarily designed to detect possible material dollar errors on the financial statements?
   a. Compliance testing.
   b. Analytical review.
   c. Computer controls.
   d. Post audit working paper review.

**M83#49.** In which of the following instances would an auditor be least likely to require the assistance of a specialist?
   a. Assessing the valuation of inventories of art works.
   b. Determining the quantities of materials stored in piles on the ground.
   c. Determining the value of unlisted securities.
   d. Ascertaining the assessed valuation of fixed assets.
**M82#51.** An attorney is responding to an independent auditor as a result of the audit client's letter of inquiry. The attorney may appropriately limit the response to
a. Asserted claims and litigation.
b. Matters to which the attorney has given substantive attention in the form of legal consultation or representation.
c. Asserted, overtly threatened, or pending claims and litigation.
d. Items which have an extremely high probability of being resolved to the client's detriment.

**M82#52.** In violation of company policy, Lowell Company erroneously capitalized the cost of painting its warehouse. The auditor examining Lowell's financial statements would most likely detect this when
a. Discussing capitalization policies with Lowell's controller.
b. Examining maintenance expense accounts.
c. Observing, during the physical inventory observation, that the warehouse had been painted.
d. Examining the construction work orders supporting items capitalized during the year.

**M82#55.** To verify that all sales transactions have been recorded, a test of transactions should be completed on a representative sample drawn from
a. Entries in the sales journal.
b. The billing clerk's file of sales orders.
c. A file of duplicate copies of sales invoices for which all prenumbered forms in the series have been accounted for.
d. The shipping clerk's file of duplicate copies of bills of lading.

**M82#56.** Which of the following statements relating to the competence of evidential matter is always true?

a. Evidential matter gathered by an auditor from outside an enterprise is reliable.
b. Accounting data developed under satisfactory conditions of internal control are more relevant than data developed under unsatisfactory internal control conditions.
c. Oral representations made by management are not valid evidence.
d. Evidence gathered by auditors must be both valid and relevant to be considered competent.
Selected Questions

M82#10. Which of the following is the best argument against the use of negative accounts receivable confirmations?
   a. The cost-per-response is excessively high.
   b. There is no way of knowing if the intended recipients received them.
   c. Recipients are likely to feel that in reality the confirmation is a subtle request for payment.
   d. The inference drawn from receiving no reply may not be correct.

M82#12. An auditor compares 1981 revenues and expenses with those of the prior year and investigates all changes exceeding 10%. By this procedure the auditor would be most likely to learn that
   a. An increase in property tax rates has not been recognized in the client's accrual.
   b. The 1981 provision for uncollectible accounts is inadequate, because of worsening economic conditions.
   c. Fourth quarter payroll taxes were not paid.
   d. The client changed its capitalization policy for small tools in 1981.

M82#14. Customers having substantial year-end past due balances fail to reply after second request forms have been mailed directly to them. Which of the following is the most appropriate audit procedure?
   a. Examine shipping documents.
   b. Review collections during the year being examined.
   c. Intensify the study of the client's system of internal control with respect to receivables.
   d. Increase the balance in the accounts receivable allowance (contra) account.

M82#15. Which of the following is the most reliable analytical review approach to verification of the year-end financial statement balances of a wholesale business?
   a. Verify depreciation expense by multiplying the depreciable asset balances by one divided by the depreciation rate.
   b. Verify commission expense by multiplying sales revenue by the company's standard commission rate.
   c. Verify interest expense, which includes imputed interest, by multiplying long term debt balances by the year-end prevailing interest rate.
   d. Verify FICA tax liability by multiplying total payroll costs by the FICA contribution rate in effect during the year.

M82#19. The third standard of field work states that sufficient competent evidential matter may, in part, be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination. The evidential matter required by this standard may, in part, be obtained through
   a. Auditor working papers.
   b. Proper planning of the audit engagement.
   c. Analytical review procedures.
   d. Review of the system of internal control.

M82#22. When auditing contingent liabilities, which of the following procedures would be least effective?
   a. Reading the minutes of the board of directors.
   b. Reviewing the bank confirmation letter.
   c. Examining customer confirmation replies.
   d. Examining invoices for professional services.

M82#49. Management's refusal to furnish a written representation on a matter which the auditor considers essential constitutes
   a. Prima facie evidence that the financial statements are not presented fairly.
   c. An uncertainty sufficient to preclude an unqualified opinion.
   d. A scope limitation sufficient to preclude an unqualified opinion.

M82#58. The controller of Excello Manufacturing, Inc., wants to use ratio analysis to identify the possible existence of idle equipment or the possibility that equipment has been disposed of without having been written off. Which of the following ratios would best accomplish this objective?
   c. Repairs and maintenance cost/direct labor costs.
   d. Gross manufacturing equipment cost/units produced.

N81#2. In the course of the examination of financial statements for the purpose of expressing an opinion thereon, the auditor will normally prepare a schedule of unadjusted differences for which the auditor did not propose adjustment when they were uncovered. What is the primary purpose served by this schedule?
   a. To point out to the responsible client officials the errors made by various company personnel.
   b. To summarize the adjustments that must be made before the company can prepare and submit its federal tax return.
   c. To identify the potential financial statement effects of errors or disputed items that were considered immaterial when discovered.
   d. To summarize the errors made by the company so that corrections can be made after the audited financial statements are released.
N81#20. If accounts receivable turned over 7.1 times in 1979 as compared to only 5.6 times in 1980, it is possible that there were
a. Unrecorded credit sales in 1980.
c. More thorough credit investigations made by the company late in 1979.
d. Fictitious sales in 1980.

N81#27. In the context of an audit of financial statements, substantive tests are audit procedures that
a. May be eliminated under certain conditions.
b. Are designed to discover significant subsequent events.
c. May be either tests of transactions, direct tests of financial balances, or analytical tests.
d. Will increase proportionately with the auditor’s reliance on internal control.

N81#34. A representation letter issued by a client
a. Is essential for the preparation of the audit program.
b. Is a substitute for testing.
c. Does not reduce the auditor’s responsibility.
d. Reduces the auditor’s responsibility only to the extent that it is relied upon.

N81#36. Which of the following procedures would ordinarily be expected to best reveal unrecorded sales at the balance sheet date?
a. Compare shipping documents with sales records.
b. Apply gross profit rates to inventory disposed of during the period.
c. Trace payments received subsequent to the balance sheet date.
d. Send accounts receivable confirmation requests.

N81#44. In verifying the amount of goodwill recorded by a client, the most convincing evidence which an auditor can obtain is by comparing the recorded value of assets acquired with the
a. Assessed value as evidenced by tax bills.
b. Seller’s book value as evidenced by financial statements.
c. Insured value as evidenced by insurance policies.
d. Appraised value as evidenced by independent appraisals.

N81#47. Which of the following elements ultimately determines the specific auditing procedures that are necessary in the circumstances to afford a reasonable basis for an opinion?
a. Auditor judgment.
b. Materiality.
c. Relative risk.
d. Reasonable assurance.

N81#48. The negative form of accounts receivable confirmation request is particularly useful except when
a. Internal control surrounding accounts receivable is considered to be effective.
b. A large number of small balances are involved.
c. The auditor has reason to believe the persons receiving the requests are likely to give them consideration.
d. Individual account balances are relatively large.

N81#57. A lawyer’s response to an auditor’s request for information concerning litigation, claims, and assessments will ordinarily contain which of the following?
a. An explanation regarding limitations on the scope of the response.
b. A statement of concurrence with the client’s determination of which unasserted possible claims warrant specification.
c. Confidential information which would be prejudicial to the client’s defense if publicized.
d. An assertion that the list of unasserted possible claims identified by the client represent all such claims of which the lawyer may be aware.

N81#58. Which of the following is not a primary objective of the auditor in the examination of accounts receivable?
a. Determine the approximate realizable value.
b. Determine the adequacy of internal controls.
c. Establish validity of the receivables.
d. Determine the approximate time of collectibility of the receivables.

M81#10. During an examination of a publicly-held company, the auditor should obtain written confirmation regarding debenture transactions from the
a. Debenture holders.
b. Client’s attorney.
c. Internal auditors.
d. Trustee.

M81#14. An audit program for the examination of the retained earnings account should include a step that requires verification of the
a. Market value used to charge retained earnings to account for a two-for-one stock split.
b. Approval of the adjustment to the beginning balance as a result of a write-down of an account receivable.
c. Authorization for both cash and stock dividends.
d. Gain or loss resulting from disposition of treasury shares.
M81#16. The accuracy of perpetual inventory records may be established, in part, by comparing perpetual inventory records with
   a. Purchase requisitions.
   b. Receiving reports.
   c. Purchase orders.
   d. Vendor payments.

M81#17. The auditor should ordinarily mail confirmation requests to all banks with which the client has conducted any business during the year, regardless of the year-end balance, since
   a. The confirmation form also seeks information about indebtedness to the bank.
   b. This procedure will detect kiting activities which would otherwise not be detected.
   c. The mailing of confirmation forms to all such banks is required by generally accepted auditing standards.
   d. This procedure relieves the auditor of any responsibility with respect to nondetection of forged checks.

M81#19. Which of the following analyses appearing in a predecessor’s working papers is the successor auditor least likely to be interested in reviewing?
   a. Analysis of noncurrent balance sheet accounts.
   b. Analysis of current balance sheet accounts.
   c. Analysis of contingencies.
   d. Analysis of income statement accounts.

M81#26. In which of the following instances would it be appropriate for the auditor to refer to the work of an appraiser in the auditor’s report?
   a. An unqualified opinion is expressed and the auditor wishes to place emphasis on the use of a specialist.
   b. A qualified opinion is expressed because of a major uncertainty unrelated to the work of the appraiser.
   c. An adverse opinion is expressed based on a difference of opinion between the client and the outside appraiser as to the value of certain assets.
   d. A disclaimer of opinion is expressed due to a scope limitation imposed on the auditor by the appraiser.

M81#37. Analytical review procedures may be classified as being primarily
   a. Compliance tests.
   b. Substantive tests.
   c. Tests of ratios.
   d. Detailed tests of balances.

M81#43. The auditor’s program for the examination of long-term debt should include steps that require the
   a. Verification of the existence of the bondholders.
   b. Examination of any bond trust indenture.
   c. Inspection of the accounts payable subsidiary ledger.
   d. Investigation of credits to the bond interest income account.

M81#55. Once a CPA has determined that accounts receivable have increased due to slow collections in a “tight money” environment, the CPA would likely to
   a. Increase the balance in the allowance for bad debts account.
   b. Review the going concern ramifications.
   c. Review the credit and collection policy.
   d. Expand tests of collectibility.

B. Specific Audit Objectives and Procedures

M85#29. To gather evidence regarding the balance per bank in a bank reconciliation, an auditor would examine all of the following except
   b. Year-end bank statement.
   c. Bank confirmation.
   d. General ledger.

M85#39. Two months before year end the bookkeeper erroneously recorded the receipt of a long-term bank loan by a debit to cash and a credit to sales. Which of the following is the most effective procedure for detecting this type of error?
   a. Analyze the notes payable journal.
   b. Analyze bank confirmation information.
   c. Prepare a year-end bank reconciliation.
   d. Prepare a year-end bank transfer schedule.

M85#57. The audit procedure of analyzing the repairs and maintenance accounts is primarily designed to provide evidence in support of the audit proposition that all
   a. Expenditures for fixed assets have been recorded in the proper period.
   b. Capital expenditures have been properly authorized.
   c. Noncapitalizable expenditures have been properly expensed.
   d. Expenditures for fixed assets have been capitalized.

N84#23. An auditor usually examines receiving reports to support entries in the
   a. Voucher register and sales returns journal.
   b. Sales journal and sales returns journal.
   c. Voucher register and sales journal.
   d. Check register and sales journal.

N84#27. An auditor would be least likely to use confirmations in connection with the examination of
   a. Inventories.
   b. Refundable income taxes.
   c. Long-term debt.
   d. Stockholders’ equity.
An auditor would be most likely to identify a contingent liability by mailing a(an)
   a. Standard bank confirmation.
   b. Related party transaction confirmation.
   c. Accounts payable confirmation.
   d. Transfer agent confirmation.

The auditor will most likely perform extensive tests for possible understatement of
   a. Revenues.
   b. Assets.
   c. Liabilities.
   d. Capital.

As one of the year-end audit procedures, the auditor instructed the client's personnel to prepare a standard bank confirmation request for a bank account that had been closed during the year. After the client's treasurer had signed the request, it was mailed by the assistant treasurer. What is the major flaw in this audit procedure?
   a. The confirmation request was signed by the treasurer.
   b. Sending the request was meaningless because the account was closed before the year-end.
   c. The request was mailed by the assistant treasurer.
   d. The CPA did not sign the confirmation request before it was mailed.

An unrecorded check issued during the last week of the year would most likely be discovered by the auditor when the
   a. Check register for the last month is reviewed.
   b. Cut-off bank statement is reconciled.
   c. Bank confirmation is reviewed.
   d. Search for unrecorded liabilities is performed.

Unrecorded liabilities are most likely to be found during the review of which of the following documents?
   a. Unpaid bills.
   b. Shipping records.
   c. Bills of lading.
   d. Unmatched sales invoices.

Tracing copies of sales invoices to shipping documents will provide evidence that all
   a. Shipments to customers were recorded as receivables.
   b. Billed sales were shipped.
   c. Debits to the subsidiary accounts receivable ledger are for sales shipped.
   d. Shipments to customers were billed.

Assuming an excellent system of internal control exists, which of the following audit procedures would be least likely to be performed?
   a. Physical inspection of a sample of inventory.
   b. Search for unrecorded cash receipts.
   c. Obtain a client representation letter.
   d. Confirmation of accounts receivable.

For which of the following ledger accounts would the auditor be most likely to analyze the details?
   a. Service Revenue.
   b. Sales.
   c. Repairs and maintenance expense.
   d. Sales salaries expense.

Which of the following factors will least affect the independent auditor's judgment as to the quantity, type, and content of working papers desirable for a particular engagement?
   a. Nature of the auditor's report.
   b. Nature of the financial statements, schedules, or other information upon which the auditor is reporting.
   c. Need for supervision and review.
   d. Number of personnel assigned to the audit.

An auditor's working papers will generally be least likely to include documentation showing how the
   a. Client's schedules were prepared.
   b. Engagement had been planned.
   c. Client's system of internal control had been reviewed and evaluated.
   d. Unusual matters were resolved.

Which of the following procedures relating to the examination of accounts payable could the auditor delegate entirely to the client's employees?
   a. Test footings in the accounts payable ledger.
   b. Reconcile unpaid invoices to vendors' statements.
   c. Prepare a schedule of accounts payable.
   d. Mail confirmations for selected account balances.

Which of the following audit procedures is least likely to detect an unrecorded liability?
   a. Analysis and recomputation of interest expense.
   b. Analysis and recomputation of depreciation expense.
   c. Mailing of standard bank confirmation form.
   d. Reading of the minutes of meetings of the board of directors.

An auditor compares information on cancelled checks with information contained in the cash disbursement journal. The objective of this test is to determine that
   a. Recorded cash disbursement transactions are properly authorized.
   b. Proper cash purchase discounts have been recorded.
   c. Cash disbursements are for goods and services actually received.
   d. No discrepancies exist between the data on the checks and the data in the journal.
Selected Questions

N81#21. Ajax, Inc., is an affiliate of the audit client and is audited by another firm of auditors. Which of the following is most likely to be used by the auditor to obtain assurance that all guarantees of the affiliate's indebtedness have been detected?
   a. Send the standard bank confirmation request to all of the client's lender banks.
   b. Review client minutes and obtain a representation letter.
   c. Examine supporting documents for all entries in intercompany accounts.
   d. Obtain written confirmation of indebtedness from the auditor of the affiliate.

N82#38. Which of the following accounts should be reviewed by the auditor to gain reasonable assurance that additions to property, plant, and equipment are not understated?
   a. Depreciation.
   b. Accounts payable.
   c. Cash.
   d. Repairs.

N82#40. An examination of the balance in the accounts payable account is ordinarily not designed to
   a. Detect accounts payable which are substantially past due.
   b. Verify that accounts payable were properly authorized.
   c. Ascertain the reasonableness of recorded liabilities.
   d. Determine that all existing liabilities at the balance sheet date have been recorded.

N81#22. Which of the following is the least persuasive documentation in support of an auditor's opinion?
   a. Schedules of details of physical inventory counts conducted by the client.
   b. Notation of inferences drawn from ratios and trends.
   c. Notation of appraisers' conclusions documented in the auditor's working papers.
   d. Lists of negative confirmation requests for which no response was received by the auditor.

N81#37. Which of the following is not a primary purpose of audit working papers?
   a. To coordinate the examination.
   b. To assist in preparation of the audit report.
   c. To support the financial statements.
   d. To provide evidence of the audit work performed.

N81#40. Which of the following is one of the better auditing techniques that might be used by an auditor to detect kiting?
   a. Review composition of authenticated deposit slips.
   b. Review subsequent bank statements and cancelled checks received directly from the banks.
   c. Prepare a schedule of bank transfers from the client's books.
   d. Prepare year-end bank reconciliations.

N81#46. A cash shortage may be concealed by transporting funds from one location to another or by converting negotiable assets to cash. Because of this, which of the following is vital?
   a. Simultaneous confirmations.
   b. Simultaneous bank reconciliations.
   c. Simultaneous verification.
   d. Simultaneous surprise cash count.

N81#49. An auditor who is engaged to examine the financial statements of a business enterprise will request a cutoff bank statement primarily in order to
   a. Verify the cash balance reported on the bank confirmation inquiry form.
   b. Verify reconciling items on the client's bank reconciliation.
   c. Detect lapping.
   d. Detect kiting.

M81#28. A common audit procedure in the audit of payroll transactions involves tracing selected items from the payroll journal to employee time cards that
have been approved by supervisory personnel. This procedure is designed to provide evidence in support of the audit proposition that

a. Only bona fide employees worked and their pay was properly computed.
b. Jobs on which employees worked were charged with the appropriate labor cost.
c. Internal controls relating to payroll disbursements are operating effectively.
d. All employees worked the number of hours for which their pay was computed.

M81#39. A CPA examines a sample of copies of December and January sales invoices for the initials of the person who verified the quantitative data. This is an example of a

a. Compliance test.
b. Substantive test.
c. Cutoff test.
d. Statistical test.

M81#40. Patentex developed a new secret formula which is of great value because it resulted in a virtual monopoly. Patentex has capitalized all research and development costs associated with this formula. Greene, CPA, who is examining this account, will probably

a. Confer with management regarding transfer of the amount from the balance sheet to the income statement.
b. Confirm that the secret formula is registered and on file with the county clerk's office.
c. Confer with management regarding a change in the title of the account to "goodwill."
d. Confer with management regarding ownership of the secret formula.

M81#45. Which of the following explanations might satisfy an auditor who discovers significant debits to an accumulated depreciation account?

a. Extraordinary repairs have lengthened the life of an asset.
b. Prior years' depreciation charges were erroneously understated.
c. A reserve for possible loss on retirement has been recorded.
d. An asset has been recorded at its fair value.

C. Other Specific Audit Topics

M85#1. Smith Corporation has numerous customers. A customer file is kept on disk storage. Each customer file contains name, address, credit limit, and account balance. The auditor wishes to test this file to determine whether credit limits are being exceeded. The best procedure for the auditor to follow would be to

a. Develop test data that would cause some account balances to exceed the credit limit and determine if the system properly detects such situations.
b. Develop a program to compare credit limits with account balances and print out the details of any account with a balance exceeding its credit limit.
c. Request a printout of all account balances so they can be manually checked against the credit limits.
d. Request a printout of a sample of account balances so they can be individually checked against the credit limits.

M85#31. When an auditor tests a computerized accounting system, which of the following is true of the test data approach?

a. Test data are processed by the client's computer programs under the auditor's control.
b. Test data must consist of all possible valid and invalid conditions.
c. Testing a program at year end provides assurance that the client's processing was accurate for the full year.
d. Several transactions of each type must be tested.

N84#11. Which of the following methods of testing application controls utilizes a generalized audit software package prepared by the auditors?

a. Parallel simulation.
b. Integrated testing facility approach.
c. Test data approach.
d. Exception report tests.

N84#13. Which of the following models expresses the general relationship of risks associated with the auditor's evaluation of internal accounting controls (IC), analytical review procedures and other relevant substantive tests (AR), and ultimate audit risk (UR), that would lead the auditor to conclude that additional substantive tests of details of an account balance are not necessary?

<table>
<thead>
<tr>
<th></th>
<th>AR</th>
<th>IC</th>
<th>UR</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>20%</td>
<td>40%</td>
<td>10%</td>
</tr>
<tr>
<td>b.</td>
<td>20%</td>
<td>60%</td>
<td>5%</td>
</tr>
<tr>
<td>c.</td>
<td>10%</td>
<td>70%</td>
<td>4½%</td>
</tr>
<tr>
<td>d.</td>
<td>30%</td>
<td>40%</td>
<td>5½%</td>
</tr>
</tbody>
</table>

N84#14. Using statistical sampling to assist in verifying the year-end accounts payable balance, an auditor has accumulated the following data:

<table>
<thead>
<tr>
<th>Number of accounts</th>
<th>Book balance</th>
<th>Balance determined by the auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>4,100</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Sample</td>
<td>200</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

Using the ratio estimation technique, the auditor's estimate of year-end accounts payable balance would be

a. $6,150,000
b. $6,000,000
c. $5,125,000
d. $5,050,000
N84#19. Which of the following is not among the errors that an auditor might include in the test data when auditing a client's EDP system?
   b. Authorization code.
   c. Differences in description of units of measure.
   d. Illogical entries in fields whose logic is tested by programmed consistency checks.

N84#29. In auditing through a computer, the test data method is used by auditors to test the
   a. Accuracy of input data.
   b. Validity of the output.
   c. Procedures contained within the program.
   d. Normalcy of distribution of test data.

N84#38. Which of the following subsequent events will be least likely to result in an adjustment to the financial statements?
   a. Culmination of events affecting the realization of accounts receivable owned as of the balance sheet date.
   b. Culmination of events affecting the realization of inventories owned as of the balance sheet date.
   c. Material changes in the settlement of liabilities which were estimated as of the balance sheet date.
   d. Material changes in the quoted market prices of listed investment securities since the balance sheet date.

M84#45. Which of the following material events occurring subsequent to the December 31, 1983, balance sheet would not ordinarily result in an adjustment to the financial statements before they are issued on March 2, 1984?
   a. Write-off of a receivable from a debtor who had suffered from deteriorating financial condition for the past 6 years. The debtor filed for bankruptcy on January 23, 1984.

M84#55. A well-prepared flowchart should make it easier for the auditor to
   a. Prepare audit procedure manuals.
   b. Prepare detailed job descriptions.
   c. Trace the origin and disposition of documents.
   d. Assess the degree of accuracy of financial data.

N83#13. In the application of statistical techniques to the estimation of dollar amounts, a preliminary sample is usually taken primarily for the purpose of estimating the population
   a. Variability.
   b. Mode.
   c. Range.
   d. Median.

N83#39. Which of the following would not necessarily be a related-party transaction?
   a. Sales to another corporation with a similar name.
   b. Purchases from another corporation that is controlled by the corporation's chief stockholder.
   c. Loan from the corporation to a major stockholder.
   d. Sale of land to the corporation by the spouse of a director.

M83#1. In which of the following cases would the auditor be most likely to conclude that all of the items in
an account under consideration should be examined rather than tested on a sample basis?

<table>
<thead>
<tr>
<th>The measure of tolerable error is</th>
<th>Error frequency is expected to be</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Large</td>
<td>Low</td>
</tr>
<tr>
<td>b. Small</td>
<td>High</td>
</tr>
<tr>
<td>c. Large</td>
<td>High</td>
</tr>
<tr>
<td>d. Small</td>
<td>Low</td>
</tr>
</tbody>
</table>

M83#4. An auditor would be most likely to consider expressing a qualified opinion or disclaimer of opinion if the client's financial statements include a footnote that
a. Lists the amounts due from related parties including the terms and manner of settlement in routine transactions.
b. Describes the influence which the client has over the other parties in certain transactions.
c. Represents that certain transactions with related parties were consummated on terms equally as favorable as would have been obtained in transactions with unrelated parties.
d. Presents the dollar volume of related party transactions and the effects of any change in the method of establishing terms from that of the prior period.

M83#53. Governmental auditing often extends beyond examinations leading to the expression of opinion on the fairness of financial presentation and includes audits of efficiency, effectiveness, and
a. Internal control.
b. Evaluation.
c. Accuracy.
d. Compliance.

M82#17. A major customer of an audit client suffers a fire just prior to completion of year-end fieldwork. The audit client believes that this event could have a significant direct effect on the financial statements. The auditor should
a. Advise management to disclose the event in notes to the financial statements.
b. Disclose the event in the auditor's report.
c. Withhold submission of the auditor's report until the extent of the direct effect on the financial statements is known.
d. Advise management to adjust the financial statements.

M82#27. More than one file may be stored on a single magnetic memory disc. Several programs may be in the core storage unit simultaneously. In both cases it is important to prevent the mixing of data. One way to do this is to use
a. File integrity control.
b. Boundary protection.
c. Interleaving.
d. Paging.

M82#36. An independent auditor finds that Simner Corporation occupies office space, at no charge, in an office building owned by a shareholder. This finding indicates the existence of
a. Management fraud.
b. Related party transactions.
c. Window dressing.
d. Weak internal control.

M82#53. In a computerized system, procedure or problem-oriented language is converted to machine language through a (an)
 a. Interpreter.
b. Verifier.
c. Compiler.
d. Converter.

N81#12. Which of the following statistical selection techniques is least desirable for use by an auditor?
 a. Systematic selection.
b. Stratified selection.
c. Block selection.
d. Sequential selection.

N81#25. An accounts receivable aging schedule was prepared on 300 pages with each page containing the aging data for 50 accounts. The pages were numbered from 1 to 300 and the accounts listed on each were numbered from 1 to 50.

Godla, an auditor, selected accounts receivable for confirmation using a table of numbers as illustrated:
### Selected Questions

**Procedures performed by Godla**

<table>
<thead>
<tr>
<th>Select column from table of numbers</th>
<th>Separate 5 digits: First 3 digits</th>
<th>Last 2 digits</th>
</tr>
</thead>
<tbody>
<tr>
<td>02011</td>
<td>020—11 x</td>
<td></td>
</tr>
<tr>
<td>85393</td>
<td>853—93 *</td>
<td></td>
</tr>
<tr>
<td>97265</td>
<td>972—65 *</td>
<td></td>
</tr>
<tr>
<td>61680</td>
<td>616—80 *</td>
<td></td>
</tr>
<tr>
<td>16656</td>
<td>166—56 *</td>
<td></td>
</tr>
<tr>
<td>42751</td>
<td>427—51 *</td>
<td></td>
</tr>
<tr>
<td>69994</td>
<td>699—94 *</td>
<td></td>
</tr>
<tr>
<td>07942</td>
<td>079—42 y</td>
<td></td>
</tr>
<tr>
<td>10231</td>
<td>102—31 z</td>
<td></td>
</tr>
<tr>
<td>53968</td>
<td>539—88 *</td>
<td></td>
</tr>
</tbody>
</table>

x Mailed confirmation to account 11 listed on page 20
y Mailed confirmation to account 42 listed on page 79
z Mailed confirmation to account 31 listed on page 102
* Rejected

This is an example of which of the following sampling methods?
- Acceptance sampling.
- Systematic sampling.
- Sequential sampling.
- Random sampling.

M81#28. Which of the following narrative disclosures appearing in notes to financial statements would an auditor be most likely to consider inappropriate?
- The related party transaction was consummated on terms no less favorable than those that would have been obtained if the transaction had been with an unrelated party.
- The accounts of subsidiaries in which the corporation has more than 50% ownership are fully consolidated.
- Legal and other costs associated with the covenant-not-to-compete will be amortized using the straight-line method during the next three years.
- Minor fluctuations in foreign currency exchange rates are not reflected in the accompanying financial statements.

M81#38. Auditors often make use of computer programs that perform routine processing functions such as sorting and merging. These programs are made available by electronic data processing companies and others and are specifically referred to as
- Compiler programs.
- Supervisory programs.
- Utility programs.
- User programs.

M81#52. “Subsequent events” for reporting purposes are defined as events which occur subsequent to the
- Balance sheet date.
- Date of the auditor’s report.
- Balance sheet date but prior to the date of the auditor’s report.
- Date of the auditor’s report and concern contingencies which are not reflected in the financial statements.

M81#11. An advantage of using statistical sampling techniques is that such techniques
- Mathematically measure risk.
- Eliminate the need for judgmental decisions.
- Define the values of precision and reliability required to provide audit satisfaction.
- Have been established in the courts to be superior to judgmental sampling.

M81#18. In estimation sampling for attributes, which one of the following must be known in order to appraise the results of the auditor’s sample?
- Estimated dollar value of the population.
- Standard deviation of the values in the population.
- Actual occurrence rate of the attribute in the population.
- Sample size.

M81#21. Assume that an auditor estimates that 10,000 checks were issued during the accounting period. If an EDP application control which performs a limit check for each check request is to be subjected to the auditor’s test-data approach, the sample should include
- Approximately 1,000 test items.
- A number of test items determined by the auditor to be sufficient under the circumstances.
- A number of test items determined by the auditor’s reference to the appropriate sampling tables.
- One transaction.

M81#25. Which of the audit procedures listed below would be least likely to disclose the existence of related party transactions of a client during the period under audit?
- Reading “conflict-of-interest” statements obtained by the client from its management.
- Scanning accounting records for large transactions at or just prior to the end of the period under audit.
- Inspecting invoices from law firms.
- Confirming large purchase and sales transactions with the vendors and/or customers involved.
M81#27. An example of a transaction which may be indicative of the existence of related parties is
   a. Borrowing or lending at a rate of interest which equals the current market rate.
   b. Selling real estate at a price that is comparable to its appraised value.
   c. Making large loans with specified terms as to when or how the funds will be repaid.
   d. Exchanging property for similar property in a nonmonetary transaction.

D. Review and Compilation Procedures

N84#49. Which one of the following is generally more important in a review than in a compilation?
   a. Determining the accounting basis on which the financial statements are to be presented.
   b. Gaining familiarity with industry accounting principles and practices.
   c. Obtaining a signed engagement letter.
   d. Obtaining a signed representation letter.

N83#33. Which of the following procedures is not included in a review engagement of a nonpublic entity?
   a. Inquiries of management.
   b. Inquiries regarding events subsequent to the balance sheet date.
   c. Any procedures designed to identify relationships among data that appear to be unusual.
   d. A study and evaluation of internal control.

M83#31. When an auditor performs a review of interim financial statements, which of the following steps would not be part of the review?
   a. Review of computer controls.
   b. Inquiry of management.
   c. Review of ratios and trends.
   d. Reading the minutes of the stockholders' meetings.

IV. Reporting

A. Reporting Standards and Types of Reports

M85#4. In which of the following reports should a CPA not express negative or limited assurance?
   a. A standard compilation report on financial statements of a nonpublic entity.
   b. A standard review report on financial statements of a nonpublic entity.
   c. A standard review report on interim financial statements of a public entity.
   d. A standard comfort letter on financial information included in a registration statement of a public entity.

M85#6. In which of the following situations would the auditor appropriately issue a report that contains the standard phrase concerning consistency?
   a. A change in the method of accounting for specific subsidiaries that comprise the group of companies for which consolidated statements are presented.
   b. A change in a financial principle that is not generally accepted to one that is generally accepted.
   c. A change in the percentage used to calculate the provision for warranty expense.
   d. Correction of a mistake in the application of a generally accepted accounting principle.

M85#11. Compiled financial statements should be accompanied by a report stating all of the following except
   a. The accountant does not express an opinion or any other form of assurance on them.
   b. A compilation has been performed.
   c. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
   d. A compilation consists principally of inquiries of company personnel and analytical procedures applied to financial data.

M85#12. A CPA's report on a forecast should include all of the following except
   a. A description of what the forecast information is intended to represent.
   b. A caveat as to the ultimate attainment of the forecasted results.
   c. A statement that the CPA assumes no responsibility to update the report for events occurring after the date of the report.
   d. An opinion as to whether the forecast is fairly presented.

M85#15. When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the independent auditor should include in the report a paragraph that
   a. States that the financial statements are not intended to be in conformity with generally accepted accounting principles.
   b. States that the financial statements are not intended to have been examined in accordance with generally accepted auditing standards.
Selected Questions

c. Refers to the authoritative pronouncements that explain the comprehensive basis of accounting being used.
d. Justifies the comprehensive basis of accounting being used.

M85#16. The auditors did not observe the taking of beginning physical inventory and were unable to satisfy themselves as to 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 with respect to
a. All of the financial statements.
b. The statement of changes in financial position.
c. The income statement.
d. The balance sheet.

M85#32. Doe, an independent auditor, was engaged to perform an examination of the financial statements of Ally Incorporated one month after its fiscal year had ended. Although the inventory count was not observed by Doe, and accounts receivable were not confirmed by direct communication with debtors, Doe was able to gain satisfaction by applying alternative auditing procedures. Doe's auditor's report will probably contain
a. A standard unqualified opinion.
b. An unqualified opinion and an explanatory middle paragraph.
c. Either a qualified opinion or a disclaimer of opinion.
d. An “except for” qualification.

M85#33. Comparative financial statements include the financial statements of a prior period which were examined by a predecessor auditor, whose report is not presented. If the predecessor auditor's report was qualified, the successor auditor must
a. Express an opinion on the current year statements alone and make no reference to the prior year statements.
b. Issue a standard short-form comparative report indicating the division of responsibility.
c. Obtain written approval from the predecessor auditor to include the prior year's financial statements.
d. Disclose the reasons for any qualification included in the predecessor auditor's opinion.

M85#36. When financial statements are presented that are not in conformity with generally accepted accounting principles an auditor may issue a(an)

<table>
<thead>
<tr>
<th>&quot;Except for&quot; opinion</th>
<th>Disclaimer of an opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M85#37. Inquiry of the entity's personnel and analytical procedures are the primary bases for the issuance of a(an)

a. Compilation report on financial statements for a nonpublic company in its first year of operations.
b. Auditor's report on financial statements supplemented with price level information.
c. Review report on comparative financial statements for a nonpublic company in its second year of operations.
d. Management advisory report prepared at the request of the client's audit committee.

M85#44. The management of a client company believes that the statement of changes in financial position is not a useful document and refuses to include one in the annual report to stockholders. As a result of this circumstance, the auditor's opinion should be

a. Qualified due to inadequate disclosure.
b. Qualified due to a scope limitation.
c. Adverse.
d. Unqualified.

Mk5#45. An auditor would issue an adverse opinion if

a. The audit was begun by other independent auditors who withdrew from the engagement.
b. A qualified opinion can not be given because the auditor lacks independence.
c. The restriction on the scope of the audit was significant.
d. The statements taken as a whole do not fairly present the financial condition and results of operations of the company.

N84#5. The statement that "nothing came to our attention which would indicate that these statements are not fairly presented" expresses which of the following?

a. Disclaimer of an opinion.
b. Negative assurance.
c. Negative confirmation.
d. Piecemeal opinion.

N84#8. The objective of a review of interim financial information is to provide the CPA with a basis for

a. Expressing a limited opinion that the financial information is presented in conformity with generally accepted accounting principles.
b. Expressing a compilation opinion on the financial information.
c. Reporting whether material modifications should be made to such information to make it conform with generally accepted accounting principles.
d. Reporting limited assurance to the board of directors only.

N84#22. If the auditor obtains satisfaction with respect to the accounts receivable balance by alternative procedures because it is impracticable to confirm ac-
counts receivable, the auditor’s report should be unqualified and could be expected to
a. Disclose that alternative procedures were used due to a client-imposed scope limitation.
b. Disclose that confirmation of accounts receivable was impracticable in the opinion paragraph.
c. Not mention the alternative procedures.
d. Refer to a footnote that discloses the alternative procedures.

N84#52. Auditors’ reports issued in connection with which of the following are generally not considered to be special reports or special purpose reports?
   a. Specified elements, accounts, or items of a financial statement.
   b. Compliance with aspects of contractual agreements related to audited financial statements.
   c. Financial statements prepared in conformity with the price-level basis of accounting.
   d. Compiled financial statements prepared in accordance with appraised liquidation values.

N84#25. Which of the following portions of a continuing auditor’s opinion paragraph on comparative financial statements is incorrect?
   a. In our opinion, the financial statements referred to above present fairly the financial position . . .
   b. Of XYZ Company as of December 31, 1980 and 1979, and the results of its operations and the changes in its financial position . . .
   c. For the years then ended, in conformity with generally accepted accounting principles . . .
   d. Applied on a basis consistent with that of the preceding year.

N84#41. The fourth reporting standard 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. An auditor from reporting on one basic financial statement and not the others.
   b. An auditor from expressing different opinions on each of the basic financial statements.
   c. Management from reducing its final responsibility for the basic financial statements.
   d. Misinterpretations regarding the degree of responsibility the auditor is assuming.

N84#50. An auditor’s opinion reads as follows: “In our opinion, except for the above-mentioned limitation on the scope of our examination. . .” This is an example of a(an)
   a. Review opinion.
   b. Emphasis of a matter.
   c. Qualified opinion.
   d. Unacceptable reporting practice.

N84#51. When a client will not make essential corporate minutes available to the auditor, the audit report will probably contain a(an)
   a. Unqualified opinion.
   b. Adverse opinion.
   c. Qualified opinion.
   d. Disclaimer of opinion.

N84#53. An auditor’s report includes a statement that, “the financial statements do not present fairly the financial position, results of operations or changes in financial position in conformity with generally accepted accounting principles.” This auditor’s report was probably issued in connection with financial statements that were
   a. Prepared on a comprehensive basis of accounting other than generally accepted accounting principles.
   b. Restricted for use by management.
   c. Misleading.
   d. Condensed.

N84#58. The auditor who wishes to point out that the entity has significant transactions with related parties should disclose this fact in
   a. An explanatory paragraph to the auditor’s report.
   b. An explanatory footnote to the financial statements.
   c. The body of the financial statements.
   d. The “Summary of significant accounting policies” section of the financial statements.

M84#3. When the audited financial statements of the prior year are presented together with those of the current year, the continuing auditor’s report should cover
   a. Both years.
   b. Only the current year.
   c. Only the current year, but the prior year’s report should be presented.
   d. Only the current year, but the prior year’s report should be referred to.

M84#4. An auditor’s report on financial statements that are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles should preferably include all of the following, except
   a. Disclosure of the fact that the financial statements are not intended to be presented in conformity with generally accepted accounting principles.
   b. An opinion as to whether the use of the disclosed method is appropriate.
Selected Questions

c. An opinion as to whether the financial statements are presented fairly in conformity with
   the basis of accounting described.

d. An opinion as to whether the disclosed basis of accounting has been applied in a manner
   consistent with the preceding period.

M84#9. Each page of the financial statements compiled by an accountant should include a reference such
   as

   a. See accompanying accountant’s footnotes.
   b. Unaudited, see accountant’s disclaimer.
   c. See accountant’s compilation report.
   d. Subject to compilation restrictions.

M84#17. During a review of financial statements of a non-public entity, the CPA would be least likely to
   
   a. Perform analytical procedures designed to identify relationships that appear to be unusual.
   b. Obtain written confirmation from management regarding loans to officers.
   c. Obtain reports from other accountants who reviewed a portion of the total entity.
   d. Read the financial statements and consider conformance with generally accepted accounting principles.

M84#18. If the auditor believes there is minimal likelihood that resolution of an uncertainty will have a
   material effect on the financial statements, the auditor should issue a(an)

   a. “Except for” opinion.
   b. Adverse opinion.
   c. Unqualified opinion.
   d. “Subject to” opinion.

M84#39. 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. No reference to the report or the work of the successor auditor.
   b. Reference to the work of the predecessor auditor in the scope and opinion paragraphs.
   c. Reference to both the work and the report of the predecessor auditor only in the opinion paragraph.
   d. Reference to the report of the predecessor auditor only in the scope paragraph.

M84#43. When, in the auditor’s judgment, the financial statements are not presented fairly in conformity
   with generally accepted accounting principles, the auditor will issue a(an)

   a. Qualified opinion.
   b. Special report.
   c. Disclaimer of opinion.
   d. Adverse opinion.

M84#45. An auditor’s examination reveals a misstatement in segment information that is material in relation to
   the financial statements taken as a whole. If the client refuses to make modifications to the presentation of
   segment information the auditor should issue a(an)

   a. “Except for” opinion.
   b. “Subject to” opinion.
   c. Unqualified opinion.
   d. Disclaimer of opinion.

M84#52. If an accounting change has no material effect on the financial statements in the current year, but
   the change is reasonably certain to have a material effect in later years, the change should be

   a. Treated as a consistency modification in the auditor’s report for the current year.
   b. Disclosed in the notes to the financial statements of the current year.
   c. Disclosed in the notes to the financial statements and referred to in the auditor’s report for the current year.
   d. Treated as a subsequent event.

M84#53. An auditor’s report included an additional paragraph disclosing that there is a difference of opinion
   between the auditor and the client for which the auditor believed an adjustment to the financial statements should be made. The opinion paragraph of the auditor’s report most likely expressed a(an)

   a. Unqualified opinion.
   b. “Except for” opinion.
   c. “Subject to” opinion.
   d. Disclaimer of opinion.

M84#57. When comparative financial statements are presented, the fourth standard of reporting, which refers to financial statements “taken as a whole,” should be considered to apply to the financial statement of the

   a. Periods presented plus one preceding period.
   b. Current period only.
   c. Current period and those of the other periods presented.
   d. Current and immediately preceding period only.

M84#59. An auditor’s standard report expressed 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. Is a component of a larger business enterprise.
   b. Has changed from the completed-contract method to the percentage-of-completion method for accounting for long-term construction contracts.
   c. Has had a significant subsequent event.
   d. Has accounting reclassifications that enhance the comparability between years.
**Auditing**

N83#1. Which one of the following would require a consistency modification in the auditor's report?
   a. Changing the salvage value of an asset.
   b. Changing the presentation of prepaid insurance from inclusion in "other assets" to disclosing it as a separate line item.
   c. Division of the consolidated subsidiary into two subsidiaries which are both consolidated.
   d. Changing from consolidating a wholly-owned subsidiary to carrying it on the equity basis.

N83#16. The first standard of reporting requires that, "the report shall state whether the financial statements are presented in accordance with generally accepted accounting principles." This should be construed to require
   a. A statement of fact by the auditor.
   b. An opinion by the auditor.
   c. An implied measure of fairness.
   d. An objective measure of compliance.

N83#17. An auditor refers to significant related party transactions in a middle paragraph of the report. If the ensuing opinion paragraph contains the words, "with the foregoing explanation," the auditor's report would be considered a(n)
   a. Unqualified opinion with appropriate reference to the middle paragraph.
   b. Example of inappropriate reporting.
   c. Adverse opinion.
   d. Negative assurance opinion.

N83#18. If management refuses to furnish certain written representations that the auditor believes are essential, which of the following is appropriate?
   a. The auditor can rely on oral evidence relating to the matter as a basis for an unqualified opinion.
   b. The client's refusal does not constitute a scope limitation that may lead to a modification of the opinion.
   c. This may have an effect on the auditor's ability to rely on other representations of management.
   d. The auditor should issue an adverse opinion because of management's refusal.

N83#26. Raider, Inc. uses the last-in, first-out method of valuation for half of its inventory and the first-in, first-out method of valuation for the other half of its inventory. Assuming the auditor is satisfied in all other respects, under these circumstances the auditor will issue a(n)
   a. Opinion modified due to inconsistency.
   b. Unqualified opinion with an explanatory middle paragraph.
   c. Qualified or adverse opinion depending upon materiality.
   d. Unqualified opinion.

N83#30. During a review of the financial statements of a nonpublic entity, the CPA finds that the financial statements contain a material departure from generally accepted accounting principles. If management refuses to correct the financial statement presentations, the CPA should
   a. Disclose the departure in a separate paragraph of the report.
   b. Issue an adverse opinion.
   c. Attach a footnote explaining the effects of the departure.
   d. Issue a compilation report.

N83#31. Which of the following will not result in modification of the auditor's report due to a scope limitation?
   a. Restrictions imposed by the client.
   b. Reliance placed on the report of another auditor.
   c. Inability to obtain sufficient competent evidential matter.
   d. Inadequacy in the accounting records.

N83#37. Whenever special reports, filed on a printed form designed by authorities, call upon the independent auditor to make an assertion that the auditor believes is not justified, the auditor should
   a. Reword the form or attach a separate report.
   b. Submit a short-form report with explanations.
   c. Submit the form with questionable items clearly omitted.
   d. Withdraw from the engagement.

N83#54. The objective of the consistency standard is to provide assurance that
   a. There are no variations in the format and presentation of financial statements.
   b. Substantially different transactions and events are not accounted for on an identical basis.
   c. The auditor is consulted before material changes are made in the application of accounting principles.
   d. The comparability of financial statements between periods is not materially affected by changes in accounting principles without disclosure.

N83#57. If a complete set of financial statements is presented on a comparative basis for two years, the auditor's opinion as it applies to the results of operations and changes in financial position would contain which of the following phrases?
   a. The two years then ended.
   b. The years then ended.
   c. Each of the two years ended.
   d. Each of the years in the two-year period ended.

M83#9. When comparative financial statements are presented but the predecessor auditor's report is not
presented, the current auditor should do which of the following in the audit report?
   a. Disclaim an opinion on the prior year's financial statements.
   b. Identify the predecessor auditor who examined the financial statements of the prior year.
   c. Make no comment with respect to the predecessor auditor's examination.
   d. Indicate the type of opinion expressed by the predecessor auditor.

M83#11. The essence of the attest function is to
   a. Detect fraud.
   b. Examine individual transactions so that the auditor may certify as to their validity.
   c. Determine whether the client's financial statements are fairly stated.
   d. Assure the consistent application of correct accounting procedures.

M83#13. A lawyer limits a response concerning a litigated claim because the lawyer is unable to determine the likelihood of an unfavorable outcome. Which type of opinion should the auditor express if the litigation is adequately disclosed and the range of potential loss is material in relation to the client's financial statements considered as a whole?
   a. Adverse.
   b. Unaudited.
   c. Qualified.
   d. Unqualified.

M83#17. Which of the following should be recognized as a consistency modification in the auditor's report, whether or not the item is fully disclosed in the financial statements?
   a. A change in accounting estimate.
   b. A change from an unacceptable accounting principle to a generally accepted one.
   c. Correction of an error not involving a change in accounting principle.
   d. A change in classification.

M83#25. A CPA who is not independent may issue a
   a. Review report.
   b. Comfort letter.
   c. Qualified opinion.
   d. Compilation report.

M83#28. When the client fails to include information that is necessary for the fair presentation of financial statements in the body of the statements or in the related footnotes, it is the responsibility of the auditor to present the information, if practicable, in the auditor's report and issue a(n)
   a. Qualified opinion or a disclaimer of opinion.
   b. Qualified opinion or an adverse opinion.
   c. Adverse opinion or a disclaimer of opinion.
   d. Qualified opinion or an unqualified opinion.

M83#30. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should issue which of the following opinions?
   a. "Except for."
   b. Disclaimer.
   c. Adverse.
   d. "Subject to."

M83#37. A company has changed its method of inventory valuation from an unacceptable one to one in conformity with generally accepted accounting principles. The auditor's report on the financial statements of the year of the change should include
   a. No reference to consistency.
   b. A reference to a prior period adjustment.
   c. A middle paragraph explaining the change.
   d. A justification for making the change and the impact of the change on reported net income.

M83#55. When the financial statements of a nonpublic entity for a prior period have not been audited and are presented, for comparative purposes, with current period statements that have been audited,
   a. The auditor should request removal of the unaudited statements since it is improper to present them for comparative purposes with audited statements.
   b. The auditor should identify the financial statements that were not examined in a separate paragraph in the auditor's report accompanying the current statements.
   c. The unaudited statements do not need to be marked "unaudited" as this may confuse the users of the statements.
   d. The auditor's report accompanying the statements should not mention that the prior period statements are unaudited, but the unaudited statements should be marked "unaudited."

N82#1. Negative assurance is not permissible in
   a. Letters required by security underwriters for data pertinent to SEC registration statements.
   b. Reports relating to the results of agreed upon procedures to one or more specified elements, accounts, or items of a financial statement.
   c. Reports based upon a review engagement.
   d. Reports based upon an audit of the interim financial statements of a closely-held business entity.

N82#5. Higgins Corporation is required to but does not wish to prepare and issue a statement of changes in financial position along with its other basic financial statements. In these circumstances, the independent
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A material change in an accounting estimate
a. Requires a consistency modification in the auditor's report and disclosure in the financial statements.
b. Requires a consistency modification in the auditor's report but does not require disclosure in the financial statements.
c. Affects comparability and may require disclosure in a note to the financial statements but does not require a consistency modification in the auditor's report.
d. Involves the acceptability of the generally acceptable accounting principles used.

The term "special reports" may include all of the following, except reports on financial statements
a. Of an organization that has limited the scope of the auditor's examination.
b. Prepared for limited purposes such as a report that relates to only certain aspects of financial statements.
c. Of a not-for-profit organization which follows accounting practices differing in some respects from those followed by business enterprises organized for profit.
d. Prepared in accordance with historical cost/constant dollar accounting.

After an auditor has issued an audit report on a nonpublic entity, there is no obligation to make any further audit tests or inquiries with respect to the audited financial statements covered by that report unless
a. New information comes to the auditor's attention concerning an event which occurred prior to the date of the auditor's report which may have affected the auditor's report.
b. Material adverse events occur after the date of the auditor's report.

c. Final determination or resolution was made on matters which had resulted in a qualification in the auditor's report.
d. Final determination or resolution was made of a contingency which had been disclosed in the financial statements.

When financial statements of a prior period are presented on a comparative basis with financial statements of the current period, the continuing auditor is responsible for
a. Expressing dual dated opinions.
b. Updating the report on the previous financial statements only if there has not been a change in the opinion.
c. Updating the report on the previous financial statements only if the previous report was qualified and the reasons for the qualification no longer exist.
d. Updating the report on the previous financial statements regardless of the opinion previously issued.

In performing a compilation of financial statements of a nonpublic entity, the accountant decides that modification of the standard report is not adequate to indicate deficiencies in the financial statements taken as a whole, and the client is not willing to correct the deficiencies. The accountant should therefore
a. Perform a review of the financial statements.
b. Issue a special report.
c. Withdraw from the engagement.
d. Express an adverse audit opinion.

It is not appropriate for the auditor's report to refer a reader to a financial statement footnote for details regarding a (an)
  a. Change in accounting principle.
  b. Limitation in the scope of the audit.
  c. Uncertainty.
  d. Related party transaction.

Which of the following best describes the reference to the expression "taken as a whole" in the fourth generally accepted auditing standard of reporting?
  a. It applies equally to a complete set of financial statements and to each individual financial statement.
  b. It applies only to a complete set of financial statements.
  c. It applies equally to each item in each financial statement.
  d. It applies equally to each material item in each financial statement.
Selected Questions

M82#60. The auditor is unable to reach a conclusion as to the propriety of management's representations. The auditor will have to consider issuing a (an)
   a. Opinion qualified because of uncertainty.
   b. Opinion qualified because of inadequate disclosure.
   c. Adverse opinion or a qualified opinion.
   d. Qualified opinion or a disclaimer of opinion.

c. A change in the companies included in combined financial statements.
   d. A correction of an error in principle.

M82#50. For financial reporting purposes, a change from straight-line to an accelerated depreciation method was disclosed in a note to the financial statements and has an immaterial effect on the current financial statements. It is expected, however, that the change will have a significant effect on future periods. The auditor should express a (an)
   a. Consistency exception.
   b. Adverse opinion.
   c. Unqualified opinion.
   d. "Subject to" opinion.

M82#56. Late in December, Tech Products Company sold its marketable securities which had appreciated in value and then repurchased them the same day. The sale and purchase transactions resulted in a large gain. Without the gain the company would have reported a loss for the year. Which of the following statements with respect to the auditor is correct?
   a. If the sale and repurchase are disclosed, an unqualified opinion should be rendered.
   b. The repurchase transaction is a sham and the auditor should insist upon a reversal or issue an adverse opinion.
   c. The auditor should withdraw from the engagement and refuse to be associated with the company.
   d. A disclaimer of opinion should be issued.

M82#60. For reporting purposes, the independent auditor should consider each of the following types of financial presentation to be a financial statement, except the statement of
   a. Changes in owners' equity.
   b. Operations by product lines.
   c. Changes in the elements of working capital.
   d. Cash receipts and disbursements.

N81#9. Under which of the following sets of circumstances might an auditor disclaim an opinion?
   a. The financial statements contain a departure from generally accepted accounting principles, the effect of which is material.
   b. The principal auditor decides to make reference to the report of another auditor who audited a subsidiary.
   c. There has been a material change between periods in the method of the application of accounting principles.
   d. There are significant uncertainties affecting the financial statements.
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N81#11. The management of Stanley Corporation has decided not to account for a material transaction in accordance with the provisions of a recent statement of the FASB. They have set forth their reasons in note "B" to the financial statements which clearly demonstrates that due to unusual circumstances the financial statements would otherwise have been misleading. The auditor's report will probably contain a (an)
   a. Consistency exception and a reference to note "B."
   b. Unqualified opinion and an explanatory middle paragraph.
   c. "Subject to" opinion and an explanatory middle paragraph.
   d. "Except for" opinion and an explanatory middle paragraph.

N81#24. An auditor includes a middle paragraph in an otherwise unqualified report in order to emphasize that the entity being reported upon is a subsidiary of another business enterprise. The inclusion of this middle paragraph
   a. Is appropriate and would not negate the unqualified opinion.
   b. Is considered a qualification of the report.
   c. Is a violation of generally accepted reporting standards if this information is disclosed in footnotes to the financial statements.
   d. Necessitates a revision of the opinion paragraph to include the phrase "with the foregoing explanation."

N81#30. When a CPA is associated with the preparation of forecasts, all of the following should be disclosed except the
   a. Sources of information.
   b. Character of the work performed by the CPA.
   c. Major assumptions in the preparation of the forecasts.
   d. Probability of achieving estimates.

N81#31. A CPA engaged to examine financial statements observes that the accounting for a certain material item is not in conformity with generally accepted accounting principles, and that this fact is prominently disclosed in a footnote to the financial statements. The CPA should
   a. Express an unqualified opinion and insert a middle paragraph emphasizing the matter by reference to the footnote.
   b. Disclaim an opinion.
   c. Not allow the accounting treatment for this item to affect the type of opinion because the deviation from generally accepted accounting principles was disclosed.
   d. Qualify the opinion because of the deviation from generally accepted accounting principles.

N81#32. When there is a change in accounting principle with which the auditor concurs, what modification, if any, should be made to the auditor's report?
   a. Modify the consistency phrase and remain silent regarding concurrence.
   b. Modify the consistency phrase and explicitly express concurrence.
   c. Not modify the consistency phrase and remain silent regarding concurrence.
   d. Not modify the consistency phrase but explicitly express concurrence.

N81#35. An auditor's report on comparative financial statements should be dated as of the date of the
   a. Issuance of the report.
   b. Completion of the auditor's recent fieldwork.
   c. Latest financial statements being reported on.
   d. Last subsequent event disclosed in the statements.

N81#58. Whenever negative assurance is provided by a CPA, it is based upon
   a. An absence of nullifying evidence.
   b. A presence of substantiating evidence.
   c. An objective examination in accordance with generally accepted auditing standards.
   d. A judgmental determination in accordance with guidelines promulgated by the AICPA.

M81#2. Once the initial audit of a newly constructed industrial plant has been performed, with respect to consistency, which of the following is of least concern to the continuing auditor in the following year?
   a. Prior years' capitalization policy.
   b. Prior years' capitalized costs.
   c. Prior years' depreciation methods.
   d. Prior years' depreciable life.

M81#13. The fourth generally accepted auditing standard of reporting requires an auditor to render a report whenever an auditor's name is associated with financial statements. The overall purpose of the fourth standard of reporting is to require that reports
   a. Assure that the auditor is independent with respect to the financial statements under examination.
   b. State that the auditor's examination of the financial statements has been conducted in accordance with generally accepted auditing standards.
   c. Indicate the character of the auditor's examination and the degree of responsibility assumed.
   d. Express whether the accounting principles used in preparing the financial statements have been applied consistently in the period under examination.
**Selected Questions**

**M81#23.** Which of the following consistency phrases would be contained in a continuing auditor’s standard report on comparative financial statements?

a. Applied on a consistent basis.
b. Applied on a basis consistent with that of the preceding year.
c. Applied consistently during interim periods.
d. Applied consistently with previous years audited.

**M81#29.** Which of the following would not be required for the statements to be “presented fairly” in conformity with generally accepted accounting principles?

a. That generally accepted accounting principles be followed in presenting all material items in the statements.
b. That the generally accepted accounting principles selected from alternatives be appropriate for the circumstances of the particular company.
c. That generally accepted accounting principles be applied on a basis consistent with those followed in the prior year.
d. That the generally accepted accounting principles selected from alternatives reflect transactions in accordance with their substance.

**M81#30.** An auditor is confronted with an exception considered sufficiently material as to warrant some deviation from the standard unqualified auditor’s report. If the exception relates to a departure from generally accepted accounting principles, the auditor must decide between expressing a (an)

a. Adverse opinion and a “subject to” opinion.
b. Adverse opinion and an “except for” opinion.
c. Adverse opinion and a disclaimer of opinion.
d. Disclaimer of opinion and a “subject to” opinion.

**M81#31.** A continuing auditor would update his opinion on prior financial statements by issuing a “subject to” opinion for the

a. Subsequent resolution of an uncertainty in the current period.
b. Discovery of an uncertainty in the current period.
c. Discovery of an uncertainty in the current period that relates to the prior-period statements being reported on.
d. Restatement of prior-period statements in conformity with generally accepted accounting principles.

**M81#33.** In which of the following circumstances would an adverse opinion be appropriate?

a. The auditor is not independent with respect to the enterprise being audited.
b. An uncertainty prevents the issuance of an unqualified opinion.
c. The statements are not in conformity with APB Opinion No. 8 regarding pension plans.
d. A client-imposed scope limitation prevents the auditor from complying with generally accepted auditing standards.

**M81#42.** An auditor’s report would be designated as a special report when it is issued in connection with which of the following?

a. Financial statements for an interim period which are subjected to a limited review.
b. Financial statements which are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.
c. Financial statements which purport to be in accordance with generally accepted accounting principles but do not include a presentation of the statement of changes in financial position.
d. Financial statements which are unaudited and are prepared from a client’s accounting records.

**M81#52.** Before reissuing a report which was previously issued on the financial statements of a prior period, a predecessor auditor should

a. Review the successor auditor’s working papers.
b. Examine significant transactions or events since the date of previous issuance.
c. Obtain a signed engagement letter from the client.
d. Obtain a letter of representation from the successor auditor.

**M81#53.** A modification of the CPA’s report on a review of the interim financial statements of a publicly-held company would be necessitated by which of the following?

a. An uncertainty.
b. Lack of consistency.
c. Reference to another accountant.
d. Inadequate disclosure.
B. Other Reporting Considerations

M84#14. When auditing a public entity's financial statements that include segment information, the auditor should

a. Make certain the segment information is labeled unaudited and determine that the information is consistent with audited information.

b. Make certain the segment information is labeled unaudited and perform only analytical review procedures on the segment information.

c. Audit the segment information and, if the information is adequate and in conformity with GAAP, do not make reference to the segment information in the auditor's report.

d. Audit the segment information and, if the information is adequate and in conformity with GAAP, refer to the segment information in the auditor's report.

M84#42. If management chooses to place supplementary information required by the FASB in footnotes attached to the financial statements, this information should be clearly marked as

a. Unaudited.

b. Supplementary information required by the FASB.

c. Disclosures required by the FASB.

d. Audited financial data required by generally accepted accounting principles.

M84#55. When an independent audit report is incorporated by reference in an SEC registration statement, a prospectus that includes a statement about the independent accountant's involvement should refer to the independent accountant as

a. Auditor of the financial reports.

b. Management's designate before the SEC.

c. Certified preparer of the report.


N84#6. The auditor's report should be dated as of the date on which the

a. Report is delivered to the client.

b. Field work is completed.

c. Fiscal period under audit ends.

d. Review of the working papers is completed.

N84#7. If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may express an opinion which states that the accompanying information is fairly stated in

a. Conformity with generally accepted accounting principles.

b. Terms of negative assurance.

c. All material respects in relation to the basic financial statements taken as a whole.

d. Conformity with principles for presenting accompanying information.

N84#12. In which of the following circumstances may the auditor issue the standard audit report?

a. The principal auditor assumes responsibility for the work of another auditor.

b. The financial statements are affected by a departure from a generally accepted accounting principle.

c. The auditor's report covers the company's first year of operations.

d. The auditor wishes to emphasize a matter regarding the financial statements.

N84#30. The auditor's inquiries of management regarding supplementary information on the effects of price level changes should be directed to the judgments made concerning

a. Relevance and validity.

b. Measurement and presentation.

c. Accuracy and objectivity.

d. Rights and obligations.

N84#34. Comfort letters are ordinarily signed by the

a. Independent auditor.

b. Client.

c. Client's lawyer.

d. Internal auditor.

N84#60. When the principal auditor decides to make reference to the other auditor's examination, the principal auditor's report should always indicate clearly, in both the scope and opinion paragraphs, the

a. Magnitude of the portion of the financial statements examined by the other auditor.

b. Name of the other auditor.

c. Division of responsibility.

d. Disclaimer of responsibility with respect to the portion of the financial statements examined by the other auditor.

M84#28. The principal auditor is satisfied with the independence and professional reputation of the other
auditor who has audited a subsidiary. To indicate the division of responsibility, the principal auditor should modify
a. Only the scope paragraph of the report.
b. Only the opinion paragraph of the report.
c. Both the scope and opinion paragraphs of the report.
d. Only the opinion paragraph of the report and include an explanatory middle paragraph.

**M84#42.** Jones, CPA, examined the 1983 financial statements of Ray Corp. and issued an unqualified opinion on March 10, 1984. On April 2, 1984, Jones became aware of a 1983 transaction that may materially affect the 1983 financial statements. This transaction would have been investigated had it come to Jones’ attention during the course of the examination. Jones should
a. Take no action because an auditor is not responsible for events subsequent to the issuance of the auditor’s report.
b. Contact Ray’s management and request their cooperation in investigating the matter.
c. Request that Ray’s management disclose the possible effects of the newly discovered transaction by adding an unaudited footnote to the 1983 financial statements.
d. Contact all parties who might rely upon the financial statements and advise them that the financial statements are misleading.

**M84#58.** When an auditor submits a document containing audited financial statements to a client, the auditor has a responsibility to report on
a. Only the basic financial statements included in the document.
b. The basic financial statements and only that additional information required to be presented in accordance with provisions of the Financial Accounting Standards Board.
c. All of the information included in the document.
d. Only that portion of the document which was audited.

**N83#58.** An auditor’s report contains the following sentences:

We did not examine the financial statements of B Company, a consolidated subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. These statements were examined by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for B Company, is based solely upon the report of the other auditors.

These sentences
a. DISCLAIM an opinion.
b. QUALIFY the opinion.
c. DIVIDE responsibility.
d. Are an improper form of reporting.

**M83#59.** After issuance of the auditor’s report, the auditor has no obligation to make any further inquiries with respect to audited financial statements covered by an auditor’s report unless a
a. Contingency is resolved.
b. Development occurs which may affect the client’s ability to continue as a going concern.
c. Material defalcation ensues.
d. History of significant non-arms-length related party transactions is discovered.

**M83#26.** If the principal auditor decides to make reference to the other auditor’s examination, the scope paragraph must specifically indicate the
a. Magnitude of the portion of the financial statements examined by the other auditor.
b. Name of the other auditor.
c. Name of the consolidated subsidiary examined by the other auditor.
d. Type of opinion expressed by the other auditor.

**M83#27.** A closely-held manufacturing company must disclose all of the following information in audited financial statements except
a. Replacement cost of inventory.
b. Any pledged inventory.
c. LIFO reserves.
d. Any changes in methods of accounting for inventory.

**M83#43.** During the current examination, an auditor who issued an unqualified report on the prior year’s financial statements becomes aware of a material unresolved uncertainty that affects the prior year financial statements presented with the current year financial statements. The auditor should
a. Qualify or disclaim an opinion in the updated report on the prior year’s financial statements.
b. Not change the opinion on the prior year’s financial statements because the uncertainty remains unresolved.
c. Express an adverse opinion in the updated report on the prior year’s financial statements.
d. Express an opinion only on the current year’s financial statements.

**N82#23.** Morgan, CPA, is the principal auditor for a multinational corporation. Another CPA has examined and reported on the financial statements of a significant subsidiary of the corporation. Morgan is satisfied with the independence and professional reputation of the other auditor, as well as the quality of the other au-(A-49)
EDITOR'S EXAMINATION. WITH RESPECT TO MORGAN'S REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS, TAKEN AS A WHOLE, MORGAN

A. MUST NOT REFER TO THE EXAMINATION OF THE OTHER AUDITOR.
B. MUST REFER TO THE EXAMINATION OF THE OTHER AUDITOR.
C. MAY REFER TO THE EXAMINATION OF THE OTHER AUDITOR.
D. MAY REFER TO THE EXAMINATION OF THE OTHER AUDITOR, IN WHICH CASE MORGAN MUST INCLUDE IN THE AUDITOR'S REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS A QUALIFIED OPINION WITH RESPECT TO THE EXAMINATION OF THE OTHER AUDITOR.

N82#34. WHEN REPORTING ON FINANCIAL STATEMENTS THAT ARE REQUIRED TO INCLUDE SEGMENT INFORMATION, THE AUDITOR'S QUANTITATIVE MEASUREMENT OF MATERIALITY WITH RESPECT TO SEGMENT INFORMATION SHOULD BE

A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

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A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

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D. DISREGARDED.

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D. DISREGARDED.

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B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

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B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

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A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

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A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

N82#34. WHEN REPORTING ON FINANCIAL STATEMENTS THAT ARE REQUIRED TO INCLUDE SEGMENT INFORMATION, THE AUDITOR'S QUANTITATIVE MEASUREMENT OF MATERIALITY WITH RESPECT TO SEGMENT INFORMATION SHOULD BE

A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

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A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

N82#34. WHEN REPORTING ON FINANCIAL STATEMENTS THAT ARE REQUIRED TO INCLUDE SEGMENT INFORMATION, THE AUDITOR'S QUANTITATIVE MEASUREMENT OF MATERIALITY WITH RESPECT TO SEGMENT INFORMATION SHOULD BE

A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

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A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

N82#34. WHEN REPORTING ON FINANCIAL STATEMENTS THAT ARE REQUIRED TO INCLUDE SEGMENT INFORMATION, THE AUDITOR'S QUANTITATIVE MEASUREMENT OF MATERIALITY WITH RESPECT TO SEGMENT INFORMATION SHOULD BE

A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

N82#34. WHEN REPORTING ON FINANCIAL STATEMENTS THAT ARE REQUIRED TO INCLUDE SEGMENT INFORMATION, THE AUDITOR'S QUANTITATIVE MEASUREMENT OF MATERIALITY WITH RESPECT TO SEGMENT INFORMATION SHOULD BE

A. DISCLOSED.
B. PRIMARILY RELATED TO THE SEGMENT INFORMATION ALONE.
C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.

N82#34. WHEN REPORTING ON FINANCIAL STATEMENTS THAT ARE REQUIRED TO INCLUDE SEGMENT INFORMATION, THE AUDITOR'S QUANTITATIVE MEASUREMENT OF MATERIALITY WITH RESPECT TO SEGMENT INFORMATION SHOULD BE

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C. PRIMARILY RELATED TO THE FINANCIAL STATEMENTS TAKEN AS A WHOLE.
D. DISREGARDED.
Selected Questions

subsidiary which is material in relation to the total examined by Thomas. It would be appropriate for Thomas to serve as the principal auditor, but it is impractical for Thomas to review the work of Jones. Assuming an unqualified opinion is expressed by Jones, one would expect Thomas to

a. Refuse to express an opinion on the consolidated financial statements.

b. Express an unqualified opinion on the consolidated financial statements and not refer to the work of Jones.

c. Express an unqualified opinion on the consolidated financial statements and refer to the work of Jones.

d. Express an "except for" opinion on the consolidated financial statements and refer to the work of Jones.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

A. General Standards and Rules of Conduct

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C. Other Responsibilities

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B. Study and Evaluation of the System

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### III. Evidence and Procedures

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### Unofficial Answers

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#### A. Reporting Standards and Types of Reports

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#### IV. Reporting

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A-55
ESSAYS — SELECTED QUESTIONS

I. Professional Responsibilities

M84
Number 3 (Estimated time — — 15 to 25 minutes)

The audit committee of the Board of Directors of Unicorn Corp. asked Tish & Field, CPAs, to audit Unicorn's financial statements for the year ended December 31, 1983. Tish & Field explained the need to make an inquiry of the predecessor auditor and requested permission to do so. Unicorn's management agreed, and authorized the predecessor auditor to respond fully to Tish & Field's inquiries.

After a satisfactory communication with the predecessor auditor, Tish & Field drafted an engagement letter that was mailed to the audit committee of the Board of Directors of Unicorn Corp. The engagement letter clearly set forth arrangements concerning the involvement of the predecessor auditor and other matters.

Required:

a. What information should Tish & Field have obtained during their inquiry of the predecessor auditor prior to acceptance of the engagement?

b. Describe what other matters would Tish & Field generally have included in the engagement letter?

II. Internal Control

A. Definitions and Basic Concepts

M82
Number 3 (Estimated time — — 15 to 25 minutes)

Jones, CPA, who has been engaged to examine the financial statements of Ajax Inc., is about to commence a study and evaluation of Ajax's system of internal control and is aware of the inherent limitations that should be considered.

Required:

a. What are the objectives of a system of internal accounting control?

b. What are the reasonable assurances that are intended to be provided by the system of internal accounting control?

c. When considering the potential effectiveness of any system of internal accounting control what are the inherent limitations that should be recognized?

N81
Number 4 (Estimated time — — 15 to 25 minutes)

Johnson, CPA, was engaged to examine the financial statements of Horizon Incorporated, which has its own computer installation. During the preliminary review, Johnson found that Horizon lacked proper segregation of the programming and operating functions. As a result, Johnson intensified the study and evaluation of the system of internal control surrounding the computer and concluded that the existing compensating general controls provided reasonable assurance that the objectives of the system of internal control were being met.

Required:

a. In a properly functioning EDP environment, how is the separation of the programming and operating functions achieved?

b. What are the compensating general controls that Johnson most likely found? Do not discuss hardware and application controls.
B. Study and Evaluation of the System

M85
Number 3 (Estimated time — 15 to 25 minutes)
The following flowchart depicts the activities relating to the shipping, billing, and collecting processes used by Smallco Lumber, Inc.

Required:

Identify weaknesses in the system of internal accounting control relating to the activities of a.) warehouse clerk, b.) bookkeeper #1, c.) bookkeeper #2, and d.) collection clerk.
N84
Number 3 (Estimated time — 15 to 25 minutes)
Cassandra Corporation, a manufacturing company, periodically invests large sums in marketable equity securities. The investment policy is established by the Investment Committee of the Board of Directors, and the treasurer is responsible for carrying out the Investment Committee's directives. All securities are stored in a bank safe deposit vault.

The independent auditor's internal control questionnaire with respect to Cassandra's investments in marketable equity securities contains the following three questions:

- Is investment policy established by the Investment Committee of the Board of Directors?
- Is the treasurer solely responsible for carrying out the Investment Committee's directives?
- Are all securities stored in a bank safe deposit vault?

Required:
In addition to the above three questions, what questions should the auditor's internal control questionnaire include with respect to the company's investments in marketable equity securities?

M81
Number 4 (Estimated time — 15 to 25 minutes)
Taylor, a CPA, has been engaged to audit the financial statements of University Books, Incorporated. University Books maintains a large revolving cash fund exclusively for the purpose of buying used books from students for cash. The cash fund is active all year because the nearby university offers a large variety of courses with varying starting and completion dates throughout the year.

Receipts are prepared for each purchase and reimbursement vouchers are periodically submitted.

Required:
Construct an internal control questionnaire to be used in the evaluation of the system of internal control of University Books's buying segments revolving cash fund. The internal control questionnaire should elicit a yes or no response. Do not discuss the internal controls over books that are purchased.
TOP MANUFACTURING CORPORATION
Flowchart of Credit Sales Activities

While auditing the Top Manufacturing Corporation the auditor prepared the above flowchart of credit sales activities. In this flowchart Code Letter "A" represents CUSTOMER.

Required:
Indicate what each of the code letters "B" through "P" represents. Do not discuss adequacies or inadequacies in the system of internal control.
Selected Questions

M84 Number 4 (Estimated time — — 15 to 25 minutes)

Talbert Corporation hired an independent computer programmer to develop a simplified payroll application for its newly purchased computer. The programmer developed an on-line, data-based microcomputer system that minimized the level of knowledge required by the operator. It was based upon typing answers to input cues that appeared on the terminal's viewing screen, examples of which follow:

A. Access routine:
   1. Operator access number to payroll file? 
   2. Are there new employees?

B. New employees routine:
   1. Employee name?
   2. Employee number?
   3. Social security number?
   4. Rate per hour?
   5. Single or married?
   6. Number of dependents?
   7. Account distribution?

C. Current payroll routine:
   1. Employee number?
   2. Regular hours worked?
   3. Overtime hours worked?
   4. Total employees this payroll period?

The independent auditor is attempting to verify that certain input validation (edit) checks exist to ensure that errors resulting from omissions, invalid entries, or other inaccuracies will be detected during the typing of answers to the input cues.

Required:
Identify the various types of input validation (edit) checks the independent auditor would expect to find in the EDP system. Describe the assurances provided by each identified validation check. Do not discuss the review and evaluation of these controls.
Properly designed and utilized forms facilitate adherence to prescribed internal accounting control policies and procedures. One such form might be a multicopy purchase order, with one copy intended to be mailed to the vendor. The remaining copies would ordinarily be distributed to the stores, purchasing, receiving and accounting departments.

The following purchase order is currently being used by National Industrial Corporation:

```
PURCHASE ORDER
SEND INVOICE ONLY TO:
297 HARDINGTEN DR., BX., NY 10461

TO ___________________________  SHIP TO ___________________________

__________________________________  _______________________________

__________________________________  _______________________________

DATE TO BE SHIPPED  SHIP VIA  DISC. TERMS  FREIGHT TERMS  ADV. ALLOWANCE  SPECIAL ALLOWANCE

QUANTITY  DESCRIPTION

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PURCHASE CONDITIONS

1 Supplier will be responsible for extra freight cost on partial shipment, unless prior permission is obtained
2 Please acknowledge this order
3 Please notify us immediately if you are unable to complete order
4 All items must be individually packed
```

Required:

a. In addition to the name of the company, what other necessary information would an auditor recommend be included in the illustrative purchase order?

b. What primary internal control functions are served by the purchase order copies that are distributed to the stores, purchasing, receiving and accounting departments?
The following illustrates a MANUAL SYSTEM FOR EXECUTING PURCHASES AND CASH DISBURSEMENTS TRANSACTIONS.

Required:
Indicate what each of the letters (A) through (L) represents. Do not discuss adequacies or inadequacies in the system of internal control.
Auditing

N82
Number 3 (Estimated time — 15 to 25 minutes)

Trapan Retailing, Inc., has decided to diversify operations by selling through vending machines. Trapan’s plans call for the purchase of 312 vending machines which will be situated at 78 different locations, within one city, and the rental of a warehouse to store merchandise. Trapan intends to sell only canned beverages at a standard price.

Management has hired an inventory control clerk to oversee the warehousing functions, and two truck drivers who will periodically fill the machines with merchandise, and deposit cash collected at a designated bank. Drivers will be required to report to the warehouse daily.

Required:

What internal controls should the auditor expect to find in order to assure the integrity of the cash receipts and warehousing functions?

N81
Number 3 (Estimated time — 15 to 25 minutes)

Dunbar Camera Manufacturing, Inc., is a manufacturer of high-priced precision motion picture cameras in which the specifications of component parts are vital to the manufacturing process. Dunbar buys valuable camera lenses and large quantities of sheetmetal and screws. Screws and lenses are ordered by Dunbar and are billed by the vendors on a unit basis. Sheetmetal is ordered by Dunbar and is billed by the vendors on the basis of weight. The receiving clerk is responsible for documenting the quality and quantity of merchandise received.

A preliminary review of the system of internal control indicates that the following procedures are being followed:

Receiving Report

1. Properly approved purchase orders, which are prenumbered, are filed numerically. The copy sent to the receiving clerk is an exact duplicate of the copy sent to the vendor. Receipts of merchandise are recorded on the duplicate copy by the receiving clerk.

Sheetmetal

2. The company receives sheetmetal by railroad. The railroad independently weighs the sheetmetal and reports the weight and date of receipt on a bill of lading (waybill), which accompanies all deliveries. The receiving clerk only checks the weight on the waybill to the purchase order.

Screws

3. The receiving clerk opens cartons containing screws, then inspects and weighs the contents. The weight is converted to number of units by means of conversion charts. The receiving clerk then checks the computed quantity to the purchase order.

Camera lenses

4. Each camera lens is delivered in a separate corrugated carton. Cartons are counted as they are received by the receiving clerk and the number of cartons are checked to purchase orders.

Required:

a. Explain why the internal control procedures as they apply individually to receiving reports and the receipt of sheetmetal, screws, and camera lenses are adequate or inadequate. Do not discuss recommendations for improvements.

b. What financial statement distortions may arise because of the inadequacies in Dunbar’s system of internal control and how may they occur?

D. Other Considerations

N82
Number 2 (Estimated time — 15 to 25 minutes)

Jiblum, CPA, is planning to use attribute sampling in order to determine the degree of reliance to be placed on an audit client’s system of internal accounting control over sales. Jiblum has begun to develop an outline of the main steps in the sampling plan as follows:

1. State the objective(s) of the audit test (e.g., to test the reliability of internal accounting controls over sales).

2. Define the population (define the period covered by the test; define the sampling unit; define the completeness of the population).

3. Define the sampling unit (e.g., client copies of sales invoices).

Required:

a. What are the remaining steps in the above outline which Jiblum should include in the statistical test of sales invoices? Do not present a detailed analysis of tasks which must be performed to carry out the objectives of each step. Parenthetical examples need not be provided.

b. How does statistical methodology help the auditor to develop a satisfactory sampling plan?
III. Evidence and Procedures

A. Audit Evidence

M85
Number 4 (Estimated time — — 15 to 25 minutes)

Smith is the partner in charge of the audit of Blue Distributing Corporation, a wholesaler that owns one warehouse containing 80% of its inventory. Smith is reviewing the working papers that were prepared to support the firm's opinion on Blue's financial statements and Smith wants to be certain essential audit records are well-documented.

Required:

a. What evidence should Smith find in the working papers to support the fact that the audit was adequately planned and the assistants were properly supervised.

b. What substantive tests should Smith expect to find in the working papers to document management's assertion about completeness as it relates to the inventory quantities at the end of the year?

N83
Number 4 (Estimated time — — 15 to 25 minutes)

Taylor, CPA, is engaged in the audit of Rex Wholesaleing for the year ended December 31, 1982. Taylor performed a proper study of the system of internal accounting control relating to the purchasing, receiving, trade accounts payable, and cash disbursement cycles and has decided not to proceed with compliance testing. Based upon analytical review procedures, Taylor believes that the trade accounts payable balance on the balance sheet as of December 31, 1982, may be understated.

Taylor requested and obtained a client-prepared trade accounts payable schedule listing the total amount owed to each vendor.

Required:

What additional substantive audit procedures should Taylor apply in examining the trade accounts payable?

N83
Number 5 (Estimated time — — 15 to 25 minutes)

Kent, CPA, who is engaged in the audit of the financial statements of Bass Corporation for the year ended December 31, 1982, is about to commence an audit of the noncurrent investment securities. Bass's records indicate that the company owns various bearer bonds, as well as 25% of the outstanding common stock of Commercial Industrial Inc. Kent is satisfied with evidence that supports the presumption of significant influence over Commercial Industrial Inc. The various securities are at two locations, as follows:

- Recently acquired securities are in the company's safe in the custody of the treasurer.
- All other securities are in the company's bank safe deposit box.

All of the securities in Bass's portfolio are actively traded in a broad market.

Required:

a. Assuming that the system of internal control over securities is satisfactory and may be relied upon, what are the objectives of the examination of these noncurrent investment securities?

b. What audit procedures should be undertaken by Kent with respect to the examination of Bass's noncurrent investment securities?

M83
Number 2 (Estimated time — — 15 to 25 minutes)

During the examination of the annual financial statements of Amis Manufacturing, Inc., the company's president, R. Alderman, and Ludy, the auditor, reviewed matters that were supposed to be included in a written representation letter. Upon receipt of the following client representation letter, Ludy contacted Alderman to state that it was incomplete.

To E. K. Ludy, CPA

In connection with your examination of the balance sheet of Amis Manufacturing, Inc. as of December 31, 1982, and the related statements of income, retained earnings, and changes in financial position for the year then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly the financial position, results of operations, and changes in financial position of Amis Manufacturing, Inc. in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your examination. There were no:

- Plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
- Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
- Agreements to repurchase assets previously sold.
Auditing

- Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
- Unasserted claims or assessments that our lawyer has advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.
- Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.
- Compensating balance or other arrangements involving restrictions on cash balances.

R. Alderman, President
Amis Manufacturing, Inc.

March 14, 1983

Required:
Identify the other matters that Alderman's representation letter should specifically confirm.

M83
Number 4 (Estimated time — 15 to 25 minutes)

The following client-prepared bank reconciliation is being examined by Kautz, CPA, during an examination of the financial statements of Cynthia Company:

Cynthia Company
BANK RECONCILIATION
VILLAGE BANK ACCOUNT 2
December 31, 1982

Balance per bank (a) $18,375.91
Deposits in Transit (b)
12/30 $1,471.10
12/31 2,840.69 4,311.79
Subtotal 22,687.70
Outstanding checks (c)
837 6,000.00
1941 671.80
1966 320.00
1984 1,855.42
1985 3,621.22
1987 2,576.89
1991 4,420.88 (19,466.21)
Subtotal 3,221.49
NSF check returned
12/29 (d) 200.00
Bank charges 5.50
Error Check No. 1932 148.10
Customer note collected by the bank ($2,750 plus $275 interest) (e) (3,025.00)
Balance per books (f) $ 550.09

Required:
Indicate one or more audit procedures that should be performed by Kautz in gathering evidence in support of each of the items (a) through (f) above.

M82
Number 4 (Estimated time — 15 to 25 minutes)

Andrews, CPA, has been engaged to examine the financial statements of Broadwall Corporation for the year ended December 31, 1981. During the year, Broadwall obtained a long-term loan from a local bank pursuant to a financing agreement which provided that the:

1. Loan was to be secured by the company's inventory and accounts receivable.
2. Company was to maintain a debt to equity ratio not to exceed two to one.
3. Company was not to pay dividends without permission from the bank.
4. Monthly installment payments were to commence July 1, 1981.

In addition, during the year the company also borrowed, on a short-term basis, from the president of the company, including substantial amounts just prior to the year end.

Required:

a. For purposes of Andrews's audit of the financial statements of Broadwall Corporation, what procedures should Andrews employ in examining the described loans? Do not discuss internal control.

b. What are the financial statement disclosures that Andrews should expect to find with respect to the loans from the president?

M82
Number 2 (Estimated time — 15 to 25 minutes)

During the year, Strang Corporation began to encounter cash flow difficulties, and a cursory review by management revealed receivable collection problems. Strang's management engaged Stanley, CPA, to perform a special investigation. Stanley studied the billing and collection cycle and noted the following:

The accounting department employs one bookkeeper who receives and opens all incoming mail. This bookkeeper is also responsible for depositing receipts, filing remittance advices on a daily basis, recording receipts in the cash receipts journal, and posting receipts in the individual customer accounts and the general ledger accounts. There are no cash sales. The bookkeeper prepares and controls the mailing of monthly statements to customers.

The concentration of functions and the receivable collection problems caused Stanley to suspect that a systematic defalcation of customers' payments through a delayed posting of remittances (lapping of accounts...
receivable) is present. Stanley was surprised to find that no customers complained about receiving erroneous monthly statements.

**Required:**
Identify the procedures which Stanley should perform to determine whether lapping exists. Do not discuss deficiencies in the system of internal control.

M81
Number 2 (Estimated time — — 15 to 25 minutes)

During an examination of the financial statements of Gole Inc., Robbins, CPA, requested and received a client-prepared property casualty insurance schedule which included appropriate premium information.

**Required:**

a. Identify the type of information, in addition to the appropriate premium information, that would ordinarily be expected to be included in a property casualty insurance schedule.

b. What are the basic audit procedures which Robbins should perform in examining the client-prepared property casualty insurance schedule?

M81
Number 5 (Estimated time — — 15 to 25 minutes)

Decker, CPA, is performing an examination of the financial statements of Allright Wholesale Sales, Inc., for the year ended December 31, 1980. Allright has been in business for many years and has never had its financial statements audited. Decker has gained satisfaction with respect to the ending inventory and is considering alternative audit procedures to gain satisfaction with respect to management’s representations concerning the beginning inventory which was not observed.

Allright sells only one product (bottled brand X beer), and maintains perpetual inventory records. In addition, Allright takes physical inventory counts monthly. Decker has already confirmed purchases with the manufacturer and has decided to concentrate on evaluating the reliability of perpetual inventory records and performing analytical review procedures to the extent that prior years’ unaudited records will enable such procedures to be performed.

**Required:**
What are the audit tests, including analytical review procedures, which Decker should apply in evaluating the reliability of perpetual inventory records and gaining satisfaction with respect to the January 1, 1980 inventory?

B. **Specific Audit Objectives and Procedures**

M84
Number 2 (Estimated time — — 15 to 25 minutes)

Pierce, an independent auditor, was engaged to examine the financial statements of Mayfair Construc-

tion Incorporated for the year ended December 31, 1983. Mayfair’s financial statements reflect a substantial amount of mobile construction equipment used in the firm’s operations. The equipment is accounted for in a subsidiary ledger. Pierce performed a study and evaluation of internal accounting control and found it satisfactory.

**Required:**
Identify the substantive audit procedures which Pierce should utilize in examining mobile construction equipment and related depreciation in Mayfair’s financial statements.

M84
Number 5 (Estimated time 15 — — 25 minutes)

Finney, CPA, was engaged to conduct an audit of the financial statements of Clayton Realty Corporation for the month ending January 31, 1984. The examination of monthly rent reconciliations is a vital portion of the audit engagement.

The following rent reconciliation was prepared by the controller of Clayton Realty Corporation and was presented to Finney who subjected it to various audit procedures:

**Clayton Realty Corporation**

**RENT RECONCILIATION**

**For the month ended**

**January 31, 1984**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross apartment rents (Schedule A)</td>
<td>$1,600,800*</td>
</tr>
<tr>
<td>Less vacancies (Schedule B)</td>
<td>20,500*</td>
</tr>
<tr>
<td>Net apartment rentals</td>
<td>1,580,300</td>
</tr>
<tr>
<td>Less unpaid January rents (Schedule C)</td>
<td>7,800*</td>
</tr>
<tr>
<td>Total</td>
<td>1,572,500</td>
</tr>
<tr>
<td>Add prepaid rent collected (Apartment 116)</td>
<td>500*</td>
</tr>
<tr>
<td>Total cash collected</td>
<td>1,573,000*</td>
</tr>
</tbody>
</table>

Schedules A, B, and C are available to Finney but have not been illustrated. Finney has conducted a study and evaluation of the system of internal control and found that it could be relied upon to produce reliable accounting information. Cash receipts from rental operations are deposited in a special bank account.

**Required:**
What substantive audit procedures should Finney employ during the audit in order to substantiate the validity of each of the dollar amounts marked by an asterisk (*)?
The following schedule was prepared by the controller of World Manufacturing Inc., for use by the independent auditors during their examination of World's year-end financial statements. All procedures performed by the audit assistant were noted at the bottom "Legend" section, and it was properly initialed, dated and indexed, and then submitted to a senior member of the audit staff for review. Internal control was reviewed and is considered to be satisfactory.

**World Manufacturing, Inc.**
**MARKETABLE SECURITIES**
**Year Ended December 31, 1981**

<table>
<thead>
<tr>
<th>Description of Security</th>
<th>Serial No.</th>
<th>Face value of bonds</th>
<th>Gen. ledger 1/1</th>
<th>Purch. in 1981</th>
<th>Sold in 1981</th>
<th>Gen. ledger 12/31</th>
<th>12/31 market</th>
<th>Dividend &amp; Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corp. Bonds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>6</td>
<td>91</td>
<td>10000</td>
<td>9400a</td>
<td>9400</td>
<td>9100</td>
<td></td>
<td>1/15</td>
</tr>
<tr>
<td>D</td>
<td>4</td>
<td>83</td>
<td>30000</td>
<td>27500a</td>
<td>27500</td>
<td>26220</td>
<td>12/1</td>
<td>1200 b,d</td>
</tr>
<tr>
<td>G</td>
<td>9</td>
<td>98</td>
<td>5000</td>
<td>4000a</td>
<td>4000</td>
<td>5080</td>
<td>8/1</td>
<td>450 b,d</td>
</tr>
<tr>
<td>Rc</td>
<td>5</td>
<td>85</td>
<td>70000</td>
<td>66000a</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sc</td>
<td>10</td>
<td>99</td>
<td>100000</td>
<td>100000e</td>
<td>100000</td>
<td>101250</td>
<td>7/1</td>
<td>5000 b,d</td>
</tr>
</tbody>
</table>

- **Stocks**
  - P 1,000 shs. 1044 7500a 7500 7600 3/1 750 b,d
  - Common 9/1 750 b,d
  - U 50 shs. 8530 9700a 9700 9800 2/1 800 b,d
  - Common 8/1 800 b,d 667

<table>
<thead>
<tr>
<th></th>
<th>17200</th>
<th>17200</th>
<th>17400</th>
<th>4600</th>
<th>917</th>
</tr>
</thead>
<tbody>
<tr>
<td>a,f</td>
<td></td>
<td>f</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f,g</td>
<td></td>
<td>f</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f</td>
<td></td>
<td>f</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f</td>
<td></td>
<td>f</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Legends and comments relative to above**
- **a** = Beginning balances agreed to 1980 working papers
- **b** = Traced to cash receipts
- **c** = Minutes examined (purchase and sales approved by the board of directors)
- **d** = Agreed to 1099
- **e** = Confirmed by tracing to broker's advice
- **f** = Totals footed
- **g** = Agreed to general ledger

**Required:**
- **a.** What information that is essential to the audit of marketable securities is missing from this schedule?
- **b.** What are the essential audit procedures that were not noted as having been performed by the audit assistant?
C. Other Specific Audit Topics

M85
Number 5 (Estimated time — — 15 to 25 minutes)

One of the generally accepted auditing standards states that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination. Some degree of uncertainty is implicit in the concept of “a reasonable basis for an opinion,” because the concept of sampling is well established in auditing practice.

Required:

a. Explain the auditor’s justification for accepting the uncertainties that are inherent in the sampling process.

b. Discuss the uncertainties which collectively embody the concept of ultimate audit risk.

c. Discuss the nature of the sampling risk and nonsampling risk. Include the effect of sampling risk on substantive tests of details and on compliance tests of internal accounting control.

IV. Reporting

A. Reporting Standards and Types of Reports

M85
Number 2 (Estimated time — — 15 to 25 minutes)

The following auditor’s report was drafted by an assistant at the completion of an audit engagement of Cramdon, Inc., and was submitted to the partner with client responsibility for review. The partner has examined matters thoroughly and has properly concluded that the opinion on the 1984 financial report should be modified only for the change in the method for computing sales. Also, due to an uncertainty a “subject to” opinion was issued on the 1983 financial statements which are included for comparative purposes. The 1983 auditor’s report was dated March 3, 1984. In 1984 the litigation against Cramdon, which was the cause of the 1983 “subject to” opinion, was resolved in favor of Cramdon.

Board of Directors of Cramdon, Inc.

We have examined the financial statements which are the representations of Cramdon, Inc., incorporated herein by reference, for the years ended December 31, 1984 and 1983. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such auditing procedures as we considered necessary in the circumstances.

As discussed in Note 7 to the financial statements, our previous opinion on the 1983 financial statements was other than unqualified pending the outcome of litigation. Due to our attorney’s meritorious defense in this litigation our opinion on these financial statements is different from that expressed in our previous report.

In our opinion, based upon the preceding, the accompanying financial statements referred to above present fairly the financial position, results of operations, and changes in financial position for the period ended December 31, 1984, in conformity with generally accepted accounting principles consistently applied, except for the change in the method of computing sales as described in Note 14 to the financial statements.

CPA
March 5, 1985

Required:

Identify the deficiencies contained in the auditor’s report as drafted by the audit assistant in the: a) scope paragraph, b) middle paragraph, and c) opinion paragraph. Rewriting the auditor’s report is not an acceptable solution.
Devon Incorporated engaged Smith to examine its financial statements for the year ended December 31, 1983. The financial statements of Devon Incorporated for the year ended December 31, 1982, were examined by Jones whose March 31, 1983, auditor's report expressed an unqualified opinion. This report of Jones is not presented with the 1983-1982 comparative financial statements.

Smith's working papers contain the following information that does not appear in footnotes to the 1983 financial statements as prepared by Devon Incorporated:

· One director appointed in 1983 was formerly a partner in Jones's accounting firm. Jones's firm provided financial consulting services to Devon during 1979 and 1978, for which Devon paid approximately $1,600 and $9,000, respectively.

· The company refused to capitalize certain lease obligations for equipment acquired in 1983. Capitalization of the leases in conformity with generally accepted accounting principles would have increased assets and liabilities by $312,000 and $387,000, respectively, and decreased retained earnings as of December 31, 1983, by $75,000, and would have decreased net income and earnings per share by $75,000 and $.75, respectively, for the year then ended. Smith has concluded that the leases should have been capitalized.

· During the year, Devon changed its method of valuing inventory from the first-in, first-out method to the last-in, first-out method. This change was made because management believes LIFO more clearly reflects net income by providing a closer matching of current costs and current revenues. The change had the effect of reducing inventory at December 31, 1983 by $65,000 and net income and earnings per share by $38,000 and $.38, respectively, for the year then ended. The effect of the change on prior years was immaterial; accordingly, there was no cumulative effect of the change. Smith firmly supports the company's position.

After completion of the field work on February 29, 1984, Smith concludes that the expression of an adverse opinion is not warranted.

Required

Prepare the body of Smith's report dated February 29, 1984, and addressed to the Board of Directors to accompany the 1983-1982 comparative financial statements.

Young and Young, CPAs, completed an examination of the financial statements of XYZ Company, Inc., for the year ended June 30, 1983, and issued a standard unqualified auditor's report dated August 15, 1983. At the time of the engagement the Board of Directors of XYZ requested a special report attesting to the adequacy of the provision for federal and state income taxes and the related accruals and deferred income taxes as presented in the June 30, 1983, financial statements.

Young and Young submitted the appropriate special report on August 22, 1983.

Required:

Prepare the special report that Young and Young should have submitted to XYZ Company, Inc.

Ross, Sandler & Co., CPAs, completed an examination of the 1982 financial statements of Fairfax Corporation on March 17, 1983, and concluded that an unqualified opinion was warranted. Because of a scope limitation arising from the inability to observe the January 1, 1981 inventory, the predecessor auditor's, Smith, Ellis & Co., issued a report which contained an unqualified opinion on the December 31, 1981 balance sheet and a qualified opinion with respect to the statements of income, retained earnings, and changes in financial position for the year then ended.

The management of Fairfax Corporation has decided to present a complete set of comparative (1982 and 1981) financial statements in their annual report.

Required:

Prepare an auditor's report assuming the March 1, 1982 auditor's report of Smith, Ellis & Co. is not presented.

The following report was drafted by an audit assistant at the completion of an audit engagement and was submitted to the auditor with client responsibility for review. The auditor has reviewed matters thoroughly and has properly concluded that the scope limitation was not client-imposed and was not sufficiently material to warrant a disclaimer of opinion although a qualified opinion was appropriate.

To Carl Corporation Controller:

We have examined the accompanying financial statements of Carl Corporation as of December 31, 1982. Our examination was made in accordance with
generally accepted auditing standards, and accordingly included such auditing procedures as we considered necessary in the circumstances.

On January 15, 1983, the company issued debentures in the amount of $1,000,000 for the purpose of financing plant expansion. As indicated in note 6 to the financial statements, the debenture agreement restricts the payment of future cash dividends to earnings after December 31, 1982.

The company's unconsolidated foreign subsidiary did not close down production during the year under examination for physical inventory purposes and took no physical inventory during the year. We made extensive tests of book inventory figures for accuracy of calculation and reasonableness of pricing. We did not make physical tests of inventory quantities. Because of this, we are unable to express an unqualified opinion on the financial statements taken as a whole. However: except for the scope limitation regarding inventory, in our opinion the accompanying balance sheet presents the financial position of Carl Corporation at December 31, 1982, subject to the effect of the inventory on the carrying value of the investment. The accompanying statements of income and of retained earnings present the incomes and expenses and the result of transactions affecting retained earnings in accordance with generally accepted accounting principles.

December 31, 1982

Pate & Co., CPAs

Required:

Identify all of the deficiencies in the above draft of the proposed report.

**M82**

**Number 5 (Estimated time — 15 to 25 minutes)**

For the year ended December 31, 1980, Novak & Co., CPAs, audited the financial statements of Tillis Ltd., and expressed an unqualified opinion dated February 27, 1981.

For the year ended December 31, 1981, Novak & Co. were engaged by Tillis Ltd. to review Tillis Ltd.'s financial statements, i.e., "look into the company's financial statements and determine whether there are any obvious modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles."

Novak made the necessary inquiries, performed the necessary analytical procedures, and performed certain additional procedures that were deemed necessary to achieve the requisite limited assurance. Novak's work was completed on March 3, 1982, and the financial statements appeared to be in conformity with generally accepted accounting principles which were consistently applied. The report was prepared on March 5, 1982. It was delivered to Jones, the controller of Tillis Ltd., on March 9, 1982.

**Required:**

Prepare the properly addressed and dated report on the comparative financial statements of Tillis Ltd., for the years ended December 31, 1980 and 1981.

**N82**

**Number 5 (Estimated time — 15 to 25 minutes)**

In order to obtain information that is necessary to make informed decisions, management often calls upon the independent auditor for assistance. This may involve a request that the independent auditor apply certain audit procedures to specific accounts of a company which is a candidate for acquisition and report upon the results. In such an engagement, the agreed-upon procedures may constitute a scope limitation.

At the completion of an engagement performed at the request of Uclean Corporation which was limited in scope as explained above, the following report was prepared by an audit assistant and was submitted to the auditor for review:

To: Board of Directors of Ajax Corporation

We have applied certain agreed-upon procedures, as discussed below, to accounting records of Ajax Corporation, as of December 31, 1981, solely to assist Uclean Corporation in connection with the proposed acquisition of Ajax Corporation.

We have examined the cash in banks and accounts receivable of Ajax Corporation as of December 31, 1981, in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the cash and receivables referred to above are fairly presented as of December 31, 1981, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. We therefore recommend that Uclean Corporation acquire Ajax Corporation pursuant to the proposed agreement.

Signature

Required:

Comment on the proposed report describing those assertions that are:

a. Incorrect or should otherwise be deleted.

b. Missing and should be inserted.

**N81**

**Number 5 (Estimated time — 15 to 25 minutes)**

Sturdy Corporation owns and operates a large office building in a desirable section of New York City's financial center. For many years the management of
Sturdy Corporation has modified the presentation of their financial statements by:

1. Reflecting a write-up to appraisal values in the building accounts.
2. Accounting for depreciation expense on the basis of such valuations.

Wyley, a successor CPA, was asked to examine the financial statements of Sturdy Corporation, for the year ended December 31, 1980. After completing the examination, Wyley concluded that, consistent with prior years, an adverse opinion would have to be expressed because of the materiality of the apparent deviation from the historical-cost principle.

Required:

a. Describe in detail the form of presentation of the middle paragraph of the auditor's report on the financial statements of Sturdy Corporation for the year ended December 31, 1980, clearly identifying the information contained in the paragraph. Do not discuss deferred taxes.

b. Write a draft of the opinion paragraph of the auditor's report on the financial statements of Sturdy Corporation for the year ended December 31, 1980.

M81
Number 3 (Estimated time — 15 to 25 minutes)

The following tentative auditor's report was drafted by a staff accountant and submitted to a partner in the accounting firm of Better & Best, CPAs:

To the Audit Committee of American Widgets, Inc.

We have examined the consolidated balance sheets of American Widgets, Inc., and subsidiaries as of December 31, 1980, and 1979, and the related consolidated statements of income, retained earnings, and changes in financial position, for the years then ended. Our examinations were made in accordance with generally accepted auditing standards as we considered necessary in the circumstances. Other auditors examined the financial statements of certain subsidiaries and have furnished us with reports thereon containing no exceptions. Our opinion expressed herein, insofar as it relates to the amounts included for those subsidiaries, is based solely upon the reports of the other auditors.

As discussed in Note 4 to the financial statements, on January 8, 1981, the company halted the production of certain medical equipment as a result of inquiries by the Food and Drug Administration, which raised questions as to the adequacy of some of the company's sterilization equipment and related procedures. Management is not in a position to evaluate the effect of this production halt and the ensuing litigation, which may have an adverse effect on the financial position of American Widgets, Inc.

As fully discussed in Note 7 to the financial statements, in 1980 the company extended the use of the last-in, first-out (LIFO) method of accounting to include all inventories. In examining inventories, we engaged Dr. Irwin Same (Nobel Prize winner 1978) to test check the technical requirements and specifications of certain items of equipment manufactured by the company.

In our opinion, except for the effects, if any, on the financial statements of the ultimate resolution of the matter discussed in the second preceding paragraph, the financial statements referred to above present fairly the financial position of American Widgets, Inc., as of December 31, 1980, and the results of operations for the years then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

To be signed by
Better & Best, CPAs

March 1, 1981 except for Note 4 as to which the date is January 8, 1981

Required:

Identify deficiencies in the staff accountant's tentative report which constitute departures from the generally accepted standards of reporting. Do not consider any AICPA exposure drafts that are currently outstanding.
SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

M84
Answer 3 (10 points)

a. Prior to acceptance of the engagement, Tish & Field should have communicated with the predecessor auditor regarding —

• Facts that might bear on the integrity of management.
• Disagreements with management concerning accounting principles, auditing procedures, or other significant matters.
• The predecessor’s understanding about the reason for the change.
• Any other information that may be of assistance in determining whether to accept the engagement.

b. The form and content of engagement letters may vary, but they would generally contain information regarding —

• The objective of the audit.
• The estimated completion date.
• Management’s responsibility for the financial statements.

• The scope of the audit.
• Other communication of the results of the engagement.
• The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered.
• Access to whatever records, documentation, and other information may be requested in connection with the audit.
• Arrangements with respect to client assistance in the performance of the audit engagement.
• Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
• Notification of any changes in the original arrangements that might be necessitated by unknown or unforeseen factors.
• Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
• The basis on which fees are computed and any billing arrangements.

II. Internal Control

A. Definitions and Basic Concepts

M82
Answer 3 (10 points)

a. Accounting control comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records.

b. A system of accounting control is designed to provide reasonable assurance that —

• Transactions are executed in accordance with management’s general or specific authorization.

• Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
• Access to assets is permitted only in accordance with management’s authorization.
• The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

c. There are inherent limitations that should be recognized in considering the potential effectiveness of any
system of accounting control. In the performance of most control procedures there are possibilities for errors arising from such causes as misunderstanding of instructions, mistakes of judgment, and personal carelessness, distraction, or fatigue. Furthermore, procedures whose effectiveness depends on segregation of duties obviously can be circumvented by collusion. Similarly, procedures designed to assure the execution and recording of transactions in accordance with management's authorizations may be ineffective against either errors or irregularities perpetrated by management with respect to transactions or to the estimates and judgments required in the preparation of financial statements. In addition to the limitations discussed above, any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate.

**Warehouse Clerk**
- Releases lumber prior to authorization, for example, approval of customer's credit.
- Copies of shipping advice should be prepared and forwarded to Bookkeeper #1.
- Lacks documentation that lumber was given to the carrier.

**Bookkeeper #1**
- Credit authorized by bookkeeper and not a responsible officer.
- Prepares and mails invoice without knowledge of what was shipped.

**Bookkeeper #2**
- Bookkeeper who maintains general ledger should not be responsible for footing and crossfooting of journals, that is, sales and cash receipts journals.
- Subsidiary accounts receivable ledger should be reconciled to general ledger.

**Collection Clerk**
- Collection clerk should not maintain sales journal.
- Collection clerk should not maintain accounts receivable subsidiary ledger.
- Remittance advice not used as the basis for posting collections.
- Checks are not promptly endorsed by the mail clerk.
- Cash receipts are not promptly deposited.
- Deposit slips are not reconciled to cash receipts journal or debits to general ledger.

**N81**
**Answer 4 (10 points)**

a. The primary internal control objectives in separating the programming and operating functions are achieved by preventing programmer access to the computer (except during designated testing periods) or to input or output documents and by preventing operator access to operating programs and operating program documentation, or by preventing operators from writing or changing programs.

b. Johnson is likely to find the following mitigating controls that are particularly important and that should exist when the programming and operating functions are not separated:
- Joint operation by two or more operators
- Rotation of operator duties
- Use of a computer activity log book
- Comparison of computer times to an average or norm
- Investigation of all excess computer time (errors)
- Adequate supervision of all EDP operations
- Periodic comparison of program code value to a control value
- Periodic comparison of all programs with control copies
- Required vacations for all employees

**B. Study and Evaluation of the System**

**N85**
**Answer 3 (10 points)**

The weaknesses in Smallco Lumber's internal accounting controls are these:

- Purchases and sales?
- Securities (including number of shares) owned?
- Stock certificate numbers?
- Dividend income?
- Gains and losses?
• Are all securities registered in the name of the company?
• Are all securities periodically inspected?
• Is the inspection performed on a surprise basis?
• Is the physical inventory of securities reconciled with the accounting records?
• Are all purchases and sales of securities executed by the treasurer within the directives of the investment committee?
• Is the amount of dividends received on individual investments periodically reconciled to published public records?
• Does the investment committee periodically review compliance with its established policy?

M81
Answer 4 (10 points)

University Books Incorporated
REVOLVING CASH FUND
INTERNAL CONTROL QUESTIONNAIRE

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is responsibility for the fund vested in one person?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is physical access to the fund denied to all others?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the custodian independent of other employees who handle cash?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the custodian bonded?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the custodian denied access to other cash funds?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are receipts unalterable?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are receipts prenumbered?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the integrity of the prenumbered sequence periodically accounted for?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does the seller sign receipts?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are receipts attached to reimbursement vouchers?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are vouchers that are submitted for reimbursement approved by someone other than the custodian?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are reimbursement vouchers and attachments (receipts) cancelled after reimbursement?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the fund used exclusively for the acquisition of books?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the fund periodically counted and reconciled by someone other than the custodian?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the fund maintained on an imprest basis?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the size of the fund appropriate for the purpose intended?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

C. Cycles

M84
Answer 4 (10 points)

Letters "B" through "P" indicate:

B. Credit Department
C. Shipping Department
D. Billing Department
E. Accounts Receivable Department
F. File pending availability of merchandise for shipment.
G. Prepare three-part sales invoice
H. Three-part sales invoice
I. Record in sales journal
J. Sales invoice - copy 3 (J and K are interchangeable)
K. Approved sales order - copy 3 (J and K are interchangeable)
L. Bill of lading - copy 2
M. Customer purchase order
N. Sales order - copy 1
O. File by customer name or customer number
P. Accounts receivable ledger

M84
Answer 4 (10 points)

The following edit checks might be used to detect errors during the typing of answers to the input cues:

• Password — ensures that the operator is authorized to access computer programs and files.
• Numeric check — ensures that numbers are entered into and accepted by the system where only numbers are required to be entered, e.g., numbers 0-9 in social security number.
• Alphabetic check — ensures that letters are entered into and accepted by the system where only letters are required to be entered, e.g., letters A-Z in employee name.
• Special-character check — ensures that only specific special characters are entered into and accepted by the system where only these special characters are required to be entered, e.g., dashes between numbers in social security number.
• Sign check — ensures that positive or negative signs are entered into and accepted by the system where only such signs are required to be entered or that the absence of a positive or negative sign appears where such an absence is required, e.g., hours worked.
• Arithmetic check — ensures the validity of the result of a mathematical computation, e.g., total employees for period equals number of employee numbers in system.
• Validity check — ensures that only authorized data codes will be entered into and accepted by the system where only such authorized data codes are required, e.g., authorized employee account numbers.
Auditing

- Limit (reasonableness) check — ensures that only data within predetermined limits will be entered into and accepted by the system, e.g., rate per hour cannot be lower than the minimum set by law or higher than the maximum set by management.
- Self-checking digit — ensures that only specific code numbers prepared by using a specific arithmetic operation will be entered into and accepted by the system, e.g., employee numbers generated by the modulus 11 method with prime-number weighting.
- Size check — ensures that only data using fixed or defined field lengths will be entered into and accepted by the system, e.g., number of dependents require exactly two digits.
- Missing-data check — ensures that no blanks will be entered into and accepted by the system when data should be present, e.g., an “S” or “M” is entered in response to single? or married?
- Overflow check — ensures that no digits are dropped if a number becomes too large for a variable during processing, e.g., hourly rates “on size errors” are detected.
- Control-total check — ensures that no unauthorized changes are made to specified data or data fields and all data have been entered.
- Logic check — ensures that spurious data are rejected, e.g., no negative regular hours.

In the accounting department purchase orders serve to
- Verify that the acquisition was authorized.
- Verify the accuracy of the terms of the vendor’s invoice.
- Authorize payment upon proof of delivery.

M83
Answer 5 (10 points)

A. Prepare purchase order
B. To vendor
C. Prepare receiving report
D. From purchasing
E. From receiving
F. Purchase order no. 5
G. Receiving report no. 1
H. Prepare and approve voucher
I. Unpaid voucher file, filed by due date
J. Treasurer
K. Sign checks and cancel voucher package documents
L. Cancelled voucher package

N82
Answer 3 (10 points)

The system of internal control should provide for—
- Drivers to count and then sign for all merchandise received.
- Daily verification of each driver’s ending inventory.
- Cash to be deposited daily by each driver.
- Daily return of duplicate deposit slips by each driver.
- Reconciliation of cash deposits with the daily net change in inventory.
- Provision for explanation of overages and shortages.
- A periodic independent surprise check of machines to verify that—
  a. Machines contain only authorized Trapan-purchased merchandise.
  b. Machines are mechanically programmed to charge the authorized prices.
  c. Cash and merchandise in machines equal a predetermined (impret) total.
- Bonding of employees.
- Alternate driver routes and required vacations.
- Restricting access to the warehouse.
- The warehouseman to count and sign for all items going into or out of the warehouse.
- Maintenance of perpetual inventory records.
- Periodic physical inventory count of merchandise in the warehouse.
- Analytical review of collections.

N81
Answer 3 (10 points)

a. The adequacy of internal control is questionable whenever quantities are not blocked out on the copy
of the purchase order that is sent to the receiving department, because this practice may cause the receiving clerk to bypass the counting and inspection procedures. The receiving clerk may only compare the purchase order and packing slip (or other document accompanying the shipment) and prepare a receiving report based on these documents. As a result of this weakness, incorrect quantities of merchandise or inferior quality merchandise may be received and accepted. However, in the case of Dunbar Manufacturing, Inc., in certain areas there are compensating controls.

*Receipt of sheetmetal.* Although the receiving clerk may only compare quantities on the purchase order and the bill of lading, there is a compensating control over quantities of sheetmetal received. This compensating control is the independent verification of weights received and date of receipt, which are provided in the bill of lading. However, sheetmetal with unacceptable quality specifications may still be received and accepted.

*Receipt of screws.* Since the receiving clerk weighs the screws upon receipt and the weight is converted to units, control over quantities received is adequate. Furthermore, screws of an unacceptable specification may be expected to be detected during the weighing and inspecting process.

*Receipt of camera lenses.* Because there are no controls that compensate for the weakness in checking actual receipt of camera lenses, there is inadequate control over the quantity and quality of lenses received.

b. Inventory may be overstated and the cost of merchandise sold and income may be misstated because additions to inventory may be based on suppliers' invoices, which may include nonusable items or items that were not received. Further, because the company may have erroneously accrued the cost of nonusable items or items not received, accounts payable may be overstated.

### D. Other Considerations

**N82**

**Answer 2** (10 points)

a. The remaining steps are as follows:

4. Define the attributes (characteristics) of interest to be tested (including the criteria for establishing the existence of errors or deviant conditions).
5. Set the maximum rate of deviations from a prescribed control procedure that would support the planned reliance on the control (tolerable rate).
6. Select a confidence level (quantify the risk of over-reliance).
7. Estimate the population error rate (deviation rate).
8. Determine the sample size.
10. Perform the compliance audit procedures.
11. Perform error analysis (calculate the deviation rate and consider the qualitative aspects of the deviations).
12. Interpret sample results (calculate a population deviation rate).
13. Decide on the acceptability of the results of the sample.

b. Statistical sampling methodology helps the auditor (1) to design an efficient sample, (2) to measure the sufficiency of the evidential matter obtained, and (3) to evaluate the sample results. By using a statistical sampling methodology, the auditor can quantify sampling risk to assist in limiting it to an acceptable level.

### III. Evidence and Procedures

#### A. Audit Evidence

**M85**

**Answer 4** (10 points)

a. Evidence found in the working papers to support the fact that the audit was adequately planned and assistants were properly supervised would be

- Documentation indicating discussions with client personnel concerning developments affecting the entity that require recognition in the audit plan.
- Documentation of a preaudit planning conference among audit firm personnel to develop an audit strategy by considering matters noted in the review of prior years' working papers, changes in accounting and auditing standards, etc.

- An internal control writeup documenting that the system of internal accounting control had been reviewed.
- Audit programs tailored to the strengths and weaknesses of the internal accounting control system.
- Audit programs indicating steps that were assigned to and completed by individual assistants.
- A budget indicating the time to be spent in each audit area.
- Individual working papers signed by reviewers to document review, approval, and responsibility.
- All questions raised by assistants were answered.

b. Substantive tests which would document management's completeness assertion as it relates to inventory quantities would be
• Observation of physical inventory counts.
• Analytical review of the relationship of inventory balances to purchase, production, and sales activities.
• Inspection of shipping and receiving documentation for proper amounts and dates to verify proper cutoff procedures.
• Obtaining confirmation of inventories at locations outside the entity.
• Tracing test counts recorded during the physical inventory observation to the inventory listing.
• Accounting for all inventory tags and count sheets used in recording the physical inventory counts.
• Recomputing the inventory calculations for clerical accuracy.
• Reconciling physical counts to perpetual records and general ledger balances and investigating significant differences.

N83
Answer 4 (10 points)

Taylor should perform the following additional substantive audit procedures.

• Foot the client-prepared schedule.
• Tie the general ledger accounts payable control account to the client-prepared accounts payable schedule.
• Examine vendors’ statements in support of items on the client-prepared schedule.
• Examine other documents (such as approved vouchers) in support of items on the client-prepared schedule.
• Review the general ledger control account for non-cash debits or unusual items, and investigate them.
• Confirm, with positive confirmation requests, account balances from vendors with account balances and vendors with zero account balances.
• Examine unpaid invoices on hand (to ascertain whether any were erroneously omitted from the client-prepared schedule of accounts payable).
• Examine documents in support of invoices paid subsequent to the year end (to ascertain whether the payable was recorded in the appropriate year).
• Inspect receiving reports (to test the accuracy of the year-end cutoff).
• Ascertain whether year-end outstanding checks to vendors were returned with the cutoff bank statement.
• Review correspondence files with respect to disputed items.
• Review open purchase orders for unusual or old items that may have been received but not recorded.
• Examine unmatched receiving reports.
• Make certain that the client representation letter includes the proper assertions concerning accounts payable.
• Investigate and resolve confirmation exceptions and other matters requiring followup.

N83
Answer 5 (10 points)
a. The auditor’s objectives during the examination of noncurrent investment securities are to obtain evidence regarding the

• Existence of the investment securities at the balance sheet date.
• Ownership of the investment securities.
• Cost and carrying value of the investment securities.
• Proper presentation and disclosure of the investment securities in the financial statements.
• Proper recognition of interest income.
• Proper recognition of investment gains and losses.

b. The following audit procedures should be undertaken by Kent in order to fulfill the audit objectives referred to above in response to part a.

• Inspect and count securities in the company’s safe and safe deposit box.
• Examine brokers’ statements to obtain assurance that all transactions were recorded.
• Examine documents in support of purchases and sales of investment securities.
• Obtain market quotations for all investment securities as of the balance sheet date.
• Inspect minutes of the board of directors meetings.
• Review the audited financial statements of the (25 percent) investor.
• Verify that the equity method of accounting was used for the carrying value of the investment in Commercial Industrial.
• Obtain a client representation letter that confirms the client’s representations concerning the noncurrent investment securities.
• Verify the calculation of interest income.
• Review the propriety of the presentation and disclosure of the securities in the financial statements.

M83
Answer 2 (10 points)

Other matters that Alderman’s representation letter should specifically confirm include whether or not—

• Management acknowledges responsibility for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (or other comprehensive basis of accounting).
• All material transactions have been properly reflected in the financial statements.
• There are other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.
• The company has satisfactory title to all owned assets, and whether there are liens or encumbrances on such assets or any pledging of assets.
Outstanding deposit
Kautz M83
Examine Trace cutoff standing
Inspect checks
All Events properly
confirm provision.
Management has been advised of all actions taken
at meetings of stockholders, board of directors, and
committees of the board of directors (or other similar
bodies) that may affect the financial statements.
All financial records and data were made available.
Management is aware of irregularities that could
have a material effect on the financial statements or
that involve management or employees who have
significant roles in the system of internal control.
Provision, when material, has been made to reduce
excess or obsolete inventories to their estimated net
realizable value.
Provision has been made for any material loss to be
sustained in the fulfillment of, or from inability to
fulfill, any sales commitments.
Provision has been made for any material loss to be
sustained as a result of purchase commitments for
inventory quantities in excess of normal require-
ments or at prices in excess of the prevailing market
prices.

M83
Answer 4 (10 points)

Basic audit procedures that should be performed by
Kautz in gathering evidence in support of each of the
items (a) through (f) are as follows:

Balance per bank (item a)

- Confirm by direct written communication with
  bank.
- Obtain and inspect a January-1983-cutoff bank
  statement directly from the bank (examine opening
  balance).

Deposit in transit (item b)

- Verify that the deposit was listed in the January-
  1983-cutoff bank statement on a timely basis.
- Trace to the cash receipts journal.
- Inspect the client’s copy of the deposit slip for the
date of deposit.

Outstanding checks (item c)

- Trace to the cash disbursements journal.
- Examine all supporting documents for those out-
  standing checks that were not returned with the
cutoff bank statement.
- Examine checks accompanying the January-1983-
cutoff bank statement and trace all 1982, or prior,
checks to the outstanding check list.

- Ascertain why check number 837 is still outstanding,
  if possible.

NSF check returned (item d)

- Follow up on the ultimate disposition of the NSF
  check.
- Examine all supporting documents.

Note collected (item e)

- Examine bank credit memo.

Balance per books (item f)

- Foot this total and compare this balance with the
general ledger balance.

N82
Answer 4 (10 points)

a. The procedures that Andrews should employ in ex-
amining the loans are as follows:

- Obtain an understanding of the business purpose of
  the loans made by the president.
- Confirm the loans, including terms, by direct com-
  munication.
- Recompute (or verify) interest expense and interest
  payable.
- Recompute the long-term and short-term portions of
  the debt.
- Review minutes of meetings of the board of direc-
  tors for proper authorization.
- Verify payments made during the year and trans-
  actions after the year end.
- Read (notes to) the financial statements and the loan
  agreements, and evaluate the adequacy of disclosure
  and compliance with restrictions.
- Obtain a management representation letter.

b. Broadwall’s financial statements should disclose the
following information concerning the loans from its
president:

- The nature of the related-party relationship
- The dollar amounts of the loans
- Amounts due the president and, if not otherwise
  apparent, the terms and manner of settlement

M82
Answer 2 (10 points)

In order to determine whether lapping exists, Stanley
would test the aging of accounts receivable and then—

- Mail positive accounts receivable confirmation re-
  quests directly to all customers with old balances.
- Investigate all exceptions noted on confirmations.
- Obtain authenticated deposit slips directly from the
  bank.
- Compare individual customers’ names, dates, and
  amounts shown on the customers’ remittance ad-
  vices with the names, dates, and amounts recorded
in the cash receipts journal, individual customer ledger accounts, and deposit slips (if practicable).
- Verify the propriety of noncash credits to accounts receivable (for example, sales discounts, sales returns, bad debt write-offs).
- Perform a surprise inspection of deposits.
- Foot the cash receipts journal, the customers' ledger accounts, and the accounts receivable control account.
- Reconcile the total of the individual customers' accounts with the accounts receivable control account.
- Compare information in copies of monthly customers' statements with information in customers' ledger accounts.

N81
Answer 2 (10 points)

a. The types of information, aside from premium information, that would ordinarily be included in an insurance schedule are as follows:

- Name of insurance companies
- Insurance policy numbers
- Type of insurance coverage
- Amount of coverage
- Time periods that are covered
- Coinsurance percentages
- Unusual riders or specified obligations

b. The basic audit procedures that Robbins should perform in examining the client-prepared insurance schedule are as follows:

- Analytically review insurance.
- Ascertain whether all major assets and all major risks are covered by insurance.
- Compare current values of assets with insured values.
- Confirm that insurance is in force.
- Vouch information on the insurance schedule to insurance policies.
- Vouch amount of premiums to client records.
- Foot appropriate columns in the insurance schedule.
- Reconcile prepaid insurance and insurance expense per insurance schedule to the balances in the client's general ledger account.
- Ascertain whether management periodically reviews the insurance coverage.

N84
Answer 2 (10 points)

Substantive audit procedures that Pierce should use in examining Mayfair's mobile construction equipment and related depreciation would include the following:

- Determine that the equipment account is properly footed.
- Determine that the subsidiary accounts agree with controlling accounts.
- Obtain, or prepare, an analysis of changes in the account during the year.
- Determine that beginning-of-year balances agree with the prior year's ending balances.
- Inspect documents in support of additions during the year.
Unofficial Answers

- Inspect documents in support of retirements during the year.
- Analyze repairs and maintenance for possible re-classifications.
- Determine the propriety of accounting for equipment not in current use.
- Test the accuracy of equipment and accounting records by —
  - Selecting items from the accounting records and verifying their physical existence.
  - Selecting items of equipment and locating them in the accounting records.
- Evaluate the reasonableness of estimated lives and methods of depreciation used.
- Test the calculation of depreciation expense and accumulated depreciation balance.
- Perform analytical review procedures such as comparing depreciation expense to balance sheet accounts for proper relationship and comparing the current year’s depreciation expense with prior year’s depreciation expense.
- Evaluate the financial statement presentation and disclosures for conformity with generally accepted accounting principles.
- Review insurance coverage.

M84

Answer 5 (10 points)

To substantiate the validity of gross apartment rents, Finney would —

- Physically examine the rental property or review architectural blueprints to ascertain the total number of rental units.
- Compare the total number of validated rental units with the total number of rent charges on the schedule of gross apartment rents (Schedule A).
- For occupied units, vouch the individual apartment rental charges per lease agreements to the individual rental charges on Schedule A.
- For unoccupied (vacant) units, ascertain the reasonableness of the scheduled rent (by reference to the last rent paid, by reference to comparable rental charges for similar units, etc.).
- Foot the gross apartment rent schedule (Schedule A) and compare the total with the figure indicated on the rent reconciliation.

To substantiate the validity of the vacancies, Finney would —

- Physically examine the apartments that were vacant during the month.
- Compare the rental charge (validated in the gross apartment rents procedures above) for each vacant apartment with the schedule of vacancies (Schedule B).

- Foot the schedule of vacancies (Schedule B) and compare the total with the total indicated on the rent reconciliation.

To substantiate the validity of unpaid January rents, Finney would —

- Trace unpaid rents from individual tenant apartment ledger cards to Schedule C.
- Foot the unpaid rents schedule (Schedule C) and compare the total with the amount shown on the rent reconciliation.
- Examine the collection file for evidence of collection attempts.
- Request written confirmations from tenants with accounts in January arrears.

To substantiate the validity of the prepaid rent collected, Finney would —

- Trace the receipt to the individual tenant apartment ledger card.
- Compare the amount collected with the lease terms.

To substantiate the validity of the cash collected, Finney would —

- Foot the client-prepared rent reconciliation.
- Reconcile the cash receipts per the rent reconciliation with the books and records.
- Confirm and reconcile the special bank account balance.

M82

Answer 4 (10 points)

a. The following information is missing:

- The date of purchase of S security
- The date of purchase and sale of R security
- Data concerning the accrual and/or receipt of interest due on R to date of sale
- Data concerning the accrual and/or payment of interest due on S to the date of purchase
- Justification for accrual and/or payment of interest due on S to the date of purchase
- Accounting treatment of bond discount
- Data concerning the December 31, 1980, revenue accruals
- Data required to evaluate the classification of securities

b. The following procedures were not noted as having been performed:

- The securities were not physically inspected or confirmed.
- The broker's advice (or other independent corroborating evidence) verifying the sale of R was not examined.
• Dividend rates were not verified by reference to public records (Standard & Poor’s) of dividend declarations.
• The stated interest rates, maturity dates, and market values were not verified.
• Computations of year-end accruals were not made.
• Not all amounts (for example, loss on sale of R) were traced to the general ledger.

C. Other Specific Audit Topics

M85
Answer 5 (10 points)

a. The auditor’s justification for accepting the uncertainties that are inherent in the sampling process are based upon the premise that the

• Cost of examining all of the financial data would usually outweigh the benefit of the added reliability of a complete (100%) examination.
• Time required to examine all of the financial data would usually preclude issuance of a timely auditor’s report.

b. The uncertainties inherent in applying auditing procedures are collectively referred to as ultimate audit risk. Ultimate audit risk, with respect to a particular account balance or class of transactions, is the risk that there is a monetary error greater than tolerable error in the balance or class that the auditor fails to detect. Ultimate audit risk is a combination of three types of risks as follows:

• Inherent risk is the risk that errors will occur in the accounting system.
• Control risk is the risk that material errors will not be detected by the client’s system of internal accounting control.
• Detection risk is the risk that any material errors that occur will not be detected by the auditor.

Ultimate audit risk includes both uncertainties due to sampling and uncertainties due to factors other than sampling. These aspects of ultimate audit risk are referred to as sampling risk and nonsampling risk, respectively.

c. Sampling risk arises from the possibility that, when a compliance or a substantive test is restricted to a sample, the auditor’s conclusions may be different from the conclusions that might be reached if the test were applied in the same way to all items in the account balance or class of transactions. That is, a particular sample may contain proportionately more or less monetary errors or compliance deviations than exist in the balance or class as a whole.

Nonsampling risk includes all the aspects of ultimate audit risk that are not due to sampling. An auditor may apply a procedure to all transactions or balances and still fail to detect a material misstatement or a material internal accounting control weakness. Nonsampling risk includes the possibility of selecting audit procedures that are not appropriate to achieve the specific objective, or failing to recognize errors in documents examined, which would render the procedure ineffective even if all items were examined.

The auditor should apply professional judgment in assessing sampling risk. In performing substantive tests of details the auditor is concerned with two aspects of sampling risk:

• The risk of incorrect acceptance is the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.
• The risk of incorrect rejection is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when it is not materially misstated.

The auditor is also concerned with two aspects of sampling risk in performing compliance tests of internal accounting control:

• The risk of overreliance on internal accounting control is the risk that the sample supports the auditor’s planned degree of reliance on the control when the true compliance rate does not justify such reliance.
• The risk of underreliance on internal accounting control is the risk that the sample does not support the auditor’s planned degree of reliance on the control when the true compliance rate supports such reliance.

The risk of incorrect acceptance and the risk of overreliance on internal accounting control relate to the effectiveness of an audit in detecting an existing material misstatement. The risk of incorrect rejection and the risk of underreliance on internal accounting control relate to the efficiency of the audit.

M81
Answer 2 (10 points)

a. A subsequent event is an event or transaction that occurs subsequent to the balance sheet date but prior to the issuance of the financial statements and auditor’s report that has a material effect on the financial statements and therefore requires adjustment or disclosure in the financial statements.

b. The occurrence of subsequent events that provide additional evidence regarding conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements necessitate financial statement adjustment. Those events that provide evidence regarding conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date ordinarily would not result in adjustment of the financial statements.
Some of these latter events, however, may be such that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the balance sheet date.

c. The specific procedures that should be performed in order to ascertain the occurrence of subsequent events are these:

- Read the latest available interim financial statements, compare them with the financial statements being reported upon, and make any other comparisons considered appropriate in the circumstances. Inquire of officers and other executives having responsibility for financial and accounting matters whether the interim statements have been prepared on the same basis as that used for the statements under examination.
- Inquire of and discuss with officers and other executives having responsibility for financial and accounting matters (limited, where appropriate, to major locations) regarding:
  a. Whether any substantial contingent liabilities or commitments existed at the date of the balance sheet being reported on or at the date of inquiry.
  b. Whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.

d. Whether any unusual adjustments have been made during the period from the balance sheet date to the date of inquiry.

- Read the available minutes of meetings of stockholders, directors, and appropriate committees; inquire about matters dealt with at meetings for which minutes are not available.
- Obtain from the client’s legal counsel a description and evaluation of any litigation, impending litigation, claims, and contingent liabilities (of which counsel has knowledge) that existed at the date of the balance sheet being reported on, together with a description and evaluation of any additional matters of such nature that have come to counsel’s attention up to the date the information is furnished.
- Obtain a letter of representations, dated as of the date of the auditor’s report, from appropriate officials (generally the chief executive officer and chief financial officer) regarding whether any events occurred subsequent to the date of the financial statements being reported on by the independent auditor that, in the officer’s opinion, would require adjustment or disclosure in these statements.
- Make such additional inquiries or perform such procedures as considered necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.

IV. Reporting

A. Reporting Standards and Types of Reports

M85
Answer 2 (10 points)

The auditor’s report contains the following deficiencies:

Scope paragraph

1. It states that the financial statements are representations of management.¹
2. The financial statements that were examined are not identified by proper names and dates.

 Opinion paragraph

1. The phrase “based upon the preceding” in the opinion is inappropriate and may be interpreted as a qualification.

¹Although this statement may be correct, the inclusion of such wording is a departure from normal language used in the scope paragraph and such modification was not requested by the partner.
2. The financial position statement should be as of a point in time and not for a period of time.
3. The company whose financial statements were examined is not identified.
4. An opinion is expressed on the 1984 financial statements only.
5. The auditor's concurrence with the inconsistent application of generally accepted accounting principles is not explicitly stated through use of the expression, "with which we concur."

N84
Answer 5 (10 points)

To the Board of Directors of Devon Incorporated:

We have examined the balance sheet of Devon Incorporated as of December 31, 1983, and the related statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The financial statements of Devon Incorporated for the year ended December 31, 1982, were examined by other auditors whose report dated March 31, 1983, expressed an unqualified opinion on those statements.

During the year, Devon changed its method of valuing inventory from the first-in, first-out method to the last-in, first-out method. This change was made because management believes LIFO more clearly reflects net income by providing a closer matching of current costs and current revenues. The change had the effect of reducing inventory at December 31, 1983, by $65,000, and net income and earnings per share by $38,000 and $.38, respectively, for the year then ended. The effect of the change on prior years was immaterial; accordingly, there was no cumulative effect of the change.

The company has excluded from property and debt in the accompanying balance sheet certain lease obligations, which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, assets would be increased by $312,000 and liabilities by $387,000, and retained earnings would be decreased by $75,000 as of December 31, 1983; net income and earnings per share would be decreased by $75,000 and $.75, respectively, for the year then ended.

In our opinion, except for the effects of not capitalizing lease obligations, and except for not disclosing the change in inventory methods as discussed in the preceding paragraphs, the financial statements referred to above present fairly the financial position of Devon Incorporated as of December 31, 1983, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding year, except for the change, with which we concur, in the method of valuing inventory as disclosed in the second preceding paragraph.

Smith, CPA

February 29, 1984

M84
Answer 2 (10 points)

Board of Directors
XYZ Company, Inc.

We have examined the financial statements of XYZ Company, Inc., for the year ended June 30, 1983, and have issued our report thereon dated August 15, 1983. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In the course of our examination, we examined the provision for federal and state income taxes for the year ended June 30, 1983, and the related accruals and deferred income taxes included in XYZ Company's financial statements referred to in the preceding paragraph. We also reviewed the federal and state income tax returns filed by XYZ Company that are subject to examination by the respective taxing authorities.

In our opinion, XYZ Company has made adequate provision for all federal and state income taxes and has properly reflected the related accruals and deferred income taxes applicable to fiscal 1983 and prior fiscal years that could be reasonably estimated at the time of our examination of the financial statements of XYZ Company, Inc., for the year ended June 30, 1983.

August 15, 1983
Young and Young
Certified Public Accountants

N83
Answer 3 (10 points)

To the shareholders and board of directors, Fairfax Corporation:

We have examined the balance sheet of Fairfax Corporation as of December 31, 1982, and the related statements of income, retained earnings, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The financial statements of Fairfax Corporation for the year ended December 31, 1981, were examined by other independent auditors, whose reports dated March 1, 1982, on those statements expressed an
unqualified opinion on the balance sheet of December 31, 1981, and a qualified opinion with respect to the statements of income, retained earnings, and changes in financial position for the year then ended due to an inability to determine the effects on these 1981 financial statements of such adjustments, if any, as might have been determined to be necessary had the January 1, 1981, physical inventory been observed.

In our opinion, the 1982 financial statements referred to above present fairly the financial position of Fairfax Corporation as of December 31, 1982, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Ross, Sandler & Co.

March 17, 1983

M83

Answer 3 (10 points)

Deficiencies in the auditor’s report, as drafted by the audit assistant, may be categorized as follows:

- The scope paragraph did not specifically identify the financial statements that were examined or the period of time they covered. Further, the scope paragraph did not specifically state that the examination included tests of accounting records, and it did not refer the reader to the second middle paragraph.

- The second middle paragraph, which should have been explanatory, improperly disclaimed an opinion on the financial statements taken as a whole.

- The opinion paragraph did not express an opinion on the results of operations and changes in financial position for the period, and the period covered by these financial statements was not identified. Further, it did not state that the balance sheet was presented fairly in conformity with generally accepted accounting principles, and it did not refer to the consistent application of generally accepted accounting principles.

If the intent was to express a qualified opinion, the reason for the qualification should have been referred to in both the scope and opinion paragraphs and the wording in the opinion paragraph should have indicated that the qualification pertained to the possible effects on the financial statements and not the scope limitation itself. Further, the “subject to” phrase should not have been used.

- The report should have been addressed to the Board of Directors; Stockholders; or Corporation.
- The date of the report should have been as of the last date of the fieldwork.

M82

Answer 5 (10 points)

To: The Board of Directors of Tillis Ltd.

We have reviewed the accompanying balance sheet of Tillis Ltd as of December 31, 1981, and the related statements of income, retained earnings, and changes in financial position for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of Tillis Ltd.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an examination 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. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying 1981 financial statements in order for them to be in conformity with generally accepted accounting principles.

The financial statements for the year ended December 31, 1980, were examined by us, and we expressed an unqualified opinion on them in our report dated February 27, 1981, but we have not performed any auditing procedures since that date.

Novak & Co.

March 3, 1982

M82

Answer 5 (10 points)

a. The assistant’s report contained the following assertions that were incorrect or that should have been deleted:

- The report was addressed to Ajax but should have been addressed to Uclean.
- It indicated that an examination (of cash in banks and accounts receivable) was performed in accordance with generally accepted auditing standards.
- It indicated that tests of the accounting records and other auditing procedures were performed as considered necessary in the circumstances.
- The report contained the phrase, “in our opinion.”
- It stated that cash in banks and accounts receivable were fairly presented in conformity with generally accepted accounting principles.
- It stated that cash in banks and accounts receivable were presented on a basis consistent with that of the preceding year.
- It recommended the acquisition of Ajax Corporation.
b. The assistant's report should contain the following:

- Disclaimer of opinion
- Indication that distribution of the report was to be restricted to named parties involved
- Enumeration of the procedures that were performed
- A statement of the findings
- Indication that the agreed-upon procedures were not sufficient to constitute an examination in accordance with generally accepted auditing standards
- Statement that the report applies only to the items specified
- Statement that the report does not extend to the financial statements of the company taken as a whole
- The date of the report

N81

Answer 5 (10 points)

a. A separate (middle) paragraph should set forth reasons for the expression of an adverse opinion and the principal effects of the subject matter of the adverse opinion. The separate paragraph should state the following, providing dollar amounts where practicable:

- The company carries its building accounts at appraisal values and provides for depreciation on the basis of such values.
- Buildings, accumulated depreciation, and equity (attributed to appraisals) are overstated.
- Net income is understated.
- Depreciation expense is overstated.

b. The opinion paragraph should contain a reference to the separate paragraph and state that the financial statements do not present fairly the financial position, results of operations, and changes in financial position. No reference to consistency should be made in the opinion paragraph. It should be worded as follows:

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of Sturdy Corporation as of December 31, 1980, or the results of its operations and changes in its financial position for the year then ended.

M81

Answer 3 (10 points)

Deficiencies in the staff accountant's tentative report include the following:

1. The report should be addressed to the company whose financial statements are being examined or to its board of directors or stockholders. The report should not generally be addressed to the audit committee.

2. The report should state that an examination was performed in accordance with generally accepted auditing standards, which includes tests of the accounting records as well as other auditing procedures.

3. When the principal auditor decides to make reference to the examination of the other auditor, the report should indicate clearly, in both the scope and opinion paragraphs, the division of responsibility regarding the portions of the financial statements examined by each. This was not done.

4. When the principal auditor decides to make reference to the examination of the other auditor, the report should disclose the magnitude of the portion of the financial statements examined by the other auditor. This was not done.

5. Reference to and identification of a specialist in the auditor's report should only occur when the auditor decides to modify the opinion as a result of the report or finding of the specialist and the auditor believes such reference will facilitate an understanding of the reason for the modification. This report should not have referred to the work of Dr. Irwin Same.

6. Although the scope paragraph referred to an examination of the financial statements for the years ended December 31, 1980, and 1979, an opinion was expressed only on the 1980 financial statements.

7. The statement of changes in financial position was not identified in the opinion paragraph, and the "consolidated" entity was not indicated.

8. When there are material uncertainties the outcome of which is not susceptible to reasonable estimation, the auditor should consider whether or not to express an unqualified opinion. In this case, it appears that the auditor's opinion should have been qualified due to the uncertainties described. A "subject to" and not an "except for" opinion would have been appropriate.

9. When there is a change in accounting principle, the opinion paragraph should be modified regarding consistency, indicating the nature of the change. Furthermore, in order to be more informative, the auditor should explicitly indicate concurrence with the change in accounting principle, unless an exception is expressly stated. Furthermore, the consistency phrase used was the phrase recommended when reporting on a single year and not the phrase recommended when reporting on comparative financial statements.

10. Generally, the date of completion of the fieldwork should be used as the date of the auditor's report. Dual dating may be used when a subsequent event disclosed in the financial statements occurs after completion of fieldwork but before issuance of the report. Since the auditor's report is dated March 1, 1981, the dual dating as of January 8, 1981, is inappropriate.
EXAMINATION IN AUDITING

November 7, 1985; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>Question</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
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<tbody>
<tr>
<td>No. 1</td>
<td>90</td>
<td>110</td>
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<tr>
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<td>15</td>
<td>25</td>
</tr>
<tr>
<td>Total</td>
<td>150</td>
<td>210</td>
</tr>
</tbody>
</table>

INSTRUCTIONS TO CANDIDATES

(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since 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.

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

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

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

Item

96. One of the generally accepted auditing standards specifies that the auditor should
   a. Inspect all property and equipment acquired during the year.
   b. Charge fair fees based on cost.
   c. Make a proper study and evaluation of the existing internal accounting control.
   d. Count client petty cash funds.

Answer Sheet

96. □ □ □ □

Items to be Answered

1. Which of the following best describes what is meant by generally accepted auditing standards?
   a. Audit objectives generally determined on audit engagements.
   b. Acts to be performed by the auditor.
   c. Measures of the quality of the auditor’s performance.
   d. Procedures to be used to gather evidence to support financial statements.

2. When a CPA is requested to perform a review engagement for a nonpublic entity in which the CPA has an immaterial financial interest, the CPA should inform management that the CPA
   a. Will have to disclose the lack of independence in the review report.
   b. Lacks independence and, therefore, may issue a review report, but can not issue an auditor’s opinion.
   c. Lacks independence and, therefore, is precluded from issuing a review report.
   d. Is considered independent because the financial interest is immaterial and, therefore, the CPA can issue a review report.

3. Quality control for a CPA firm, as referred to in Statements on Quality Control Standards, applies to
   a. Auditing services only.
   b. Auditing and management advisory services.
   c. Auditing and tax services.
   d. Auditing and accounting and review services.

4. In which of the following circumstances would a CPA who audits XM Corporation lack independence?
   a. The CPA and XM’s president are both on the board of directors of COD Corporation.
   b. The CPA and XM’s president each owns 25% of FOB Corporation, a closely held company.
   c. The CPA has a home mortgage from XM, which is a savings and loan organization.
   d. The CPA reduced XM’s usual audit fee by 40% because XM’s financial condition was unfavorable.

5. If an auditor detects an illegal act that does not have a material effect on the client’s financial statements, the auditor should generally
   a. Require that the circumstances be disclosed in the notes to the financial statements.
   b. Require the illegal act be reported to the proper legal authorities.
   c. Report on the illegal act in a separate paragraph of the auditor’s report.
   d. Report the circumstances to a high-level officer within the client’s firm.

6. A management advisory service engagement, as opposed to a management advisory service consultation, generally involves advice or information given by a CPA that is based upon
   a. An analytical approach and process.
   b. Existing personal knowledge about the client.
   c. An incidental effort devoted to a combination of activities.
   d. The CPA’s ability to implement management’s recommendations.

7. Which of the following statements best describes why the CPA profession has deemed it essential to promulgate ethical standards and to establish means for ensuring their observance?
   a. A requirement for a profession is the establishment of ethical standards that stress primarily a responsibility to clients and colleagues.
   b. A requirement of most state laws calls for the profession to establish a code of ethics.
   c. An essential means of self-protection for the profession is the establishment of flexible ethical standards by the profession.
   d. A distinguishing mark of a profession is its acceptance of responsibility to the public.

8. In general, material irregularities perpetrated by which of the following are most difficult to detect?
   a. Internal auditor.
   b. Key-punch operator.
   c. Cashier.
   d. Controller.
9. In planning a new engagement, which of the following is not a factor that affects the CPA's judgment as to the quantity, type, and content of working papers?
   a. The content of the client's representation letter.
   b. The type of report to be issued by the CPA.
   c. The CPA's estimated occurrence rate of attributes.
   d. The CPA's preliminary evaluations based on discussions with the client.

10. A prospective client's refusal to grant a CPA permission to communicate with the predecessor auditor will bear directly on the CPA's ability to
   a. Study and evaluate the client's system of internal control.
   b. Determine the integrity of management.
   c. Determine the beginning balances of the current year's financial statements.
   d. Establish consistency in application of GAAP between years.

11. With respect to errors and irregularities, the auditor should plan to
   a. Search for errors or irregularities that would have a material effect on the financial statements.
   b. Discover errors or irregularities that have either material or immaterial effect on the financial statements.
   c. Search for errors that would have a material effect and for irregularities that would have either material or immaterial effect on the financial statements.
   d. Search for irregularities that would have a material effect and for errors that would have either material or immaterial effect on the financial statements.

12. The technical standards that apply to MAS engagements require the MAS practitioner to do all of the following except
   a. Maintain independence from the client.
   b. Give support for and clearly identify any quantifiable results that are based on estimates.
   c. Obtain an understanding concerning the nature, scope, and limitations of the MAS engagement to be performed.
   d. Take no position which might impair the practitioner's objectivity.

13. The first general standard recognizes that regardless of how capable an individual may be in other fields, the individual can not meet the requirements of the auditing standards without the proper
   a. Business and finance courses.
   b. Quality control and peer review.
   c. Education and experience in auditing.
   d. Supervision and review skills.

14. The third general standard states that due care is to be exercised in the performance of the examination. This standard means that a CPA who undertakes an engagement assumes a duty to perform each audit
   a. As a professional possessing the degree of skill commonly possessed by others in the field.
   b. In conformity with generally accepted accounting principles.
   c. With reasonable diligence and without fault or error.
   d. To the satisfaction of governmental agencies and investors who rely upon the audit.

15. The independent auditor selects several transactions in each functional area and traces them through the entire system, paying special attention to evidence about whether or not the control features are in operation. This is an example of a
   a. Control test.
   b. Compliance test.
   c. Substantive test.
   d. Functional test.

16. In the evaluation of internal accounting control, the auditor is basically concerned that the system provides reasonable assurance that
   a. Management can not override the system.
   b. Operational efficiency has been achieved in accordance with management plans.
   c. Errors have been prevented or detected.
   d. Controls have not been circumvented by collusion.

17. Which of the following statements with respect to the independent auditor's evaluation of internal accounting control is correct?
   a. The auditor should decrease compliance testing when weaknesses in cash receipts are mitigated by strong controls in cash disbursement procedures.
   b. The auditor should increase compliance testing when weaknesses in billing procedures are mitigated by strong controls in collection procedures.
   c. The auditor generally should not evaluate separately procedures that result in entries to specific accounts but should confine the evaluation to broad classes of transactions.
   d. The auditor should evaluate all internal accounting control weaknesses before determining the accounting control procedures that should prevent or detect errors and irregularities.

18. When evaluating an internal accounting control system to determine whether the necessary procedures are prescribed and are followed satisfactorily, an auditor must
   a. Develop questionnaires and checklists.
   b. Review the system and perform compliance tests.
   c. Perform compliance and analytical review tests.
   d. Evaluate administrative policies.
19. Tracing bills of lading to sales invoices will provide evidence that
   a. Recorded sales were shipped.
   b. Invoiced sales were shipped.
   c. Shipments to customers were invoiced.
   d. Shipments to customers were recorded as sales.

20. Which of the following accounts would most likely be reviewed by the auditor to gain reasonable assurance that additions to the equipment account are not understated?
   a. Repairs and maintenance expense.
   b. Depreciation expense.
   c. Gain on disposal of equipment.
   d. Accounts payable.

Items 21 through 26 are based on the following information:

Hickory, Inc., is a small manufacturer. Its office building, plant, and warehouse are all located in Zena, Ohio. William Cream is the principal owner and president of Hickory.

Hickory is not a publicly-held corporation. The primary uses of the financial statements are for its 15 shareholders and for bank credit purposes. Hickory's financial statements have never been audited or reviewed.


Part & Co. has offices in Cleveland, the office that performed the Hickory audit, and Chicago.

21. After the preliminary phase of the review of Hickory's internal accounting controls, Part & Co. decided not to perform compliance testing, but rather to restrict audit procedures to substantive testing. Part has probably decided that Hickory's internal accounting controls are
   a. Adequate enough to justify reliance on them.
   b. So good that compliance testing would provide little benefit.
   c. So inadequate that the performance of compliance tests would not provide a basis for reliance on them.
   d. So inadequate that Part does not even understand the flow of transactions, and therefore it would be impossible to perform compliance testing.

22. Hickory's client representation letter should be dated

23. If Part & Co. were able to examine satisfactory evidence for all items in the financial statements except verification of Hickory's January 1, 1984, inventory quantities, Part's opinion on Hickory's 1984 financial statements will probably be
   a. A disclaimer for both the balance sheet and income statement.
   b. A disclaimer for the balance sheet and unqualified for the income statement.
   c. Unqualified for the balance sheet and "subject to" for the income statement.
   d. Unqualified for the balance sheet and a disclaimer for the income statement.

24. Hickory will present comparative financial statements for 1983 and 1984. What procedures should Part & Co. adopt relating to the 1983 financial information?
   a. Part should perform sufficient analytical review procedures in order to assure that there are only immaterial differences between 1983 balances and 1984 balances.
   b. Part should perform sufficient procedures in order to assure that accounting principles employed are consistent between 1983 and 1984.
   c. Since the 1983 financial statements are included with the audited 1984 financial statements, Part must perform an examination of the 1983 financial statements in accordance with GAAS.
   d. Since the 1983 financial statements are unaudited, no procedures are required.

25. Which of the following subsequent events occurring between January 1, 1985 and March 10, 1985, would cause Hickory to adjust its 1984 financial statements?
   a. Short-term investments' aggregate market value declined substantially below cost.
   b. Hickory sold its accounts receivable to a local financial institution.
   c. Hickory issued common stock to settle a current liability that existed as of the balance sheet date.
   d. William Cream sold all of his common stock in Hickory to Hickory.

26. In order for Part & Co. to be considered independent with respect to the Hickory audit, which of the following individuals would most likely be permitted to own an immaterial direct financial interest in Hickory?
   a. Professional employees at either office.
   b. Professional employees at the Chicago office.
   c. Professional employees and partners at the Chicago office.
   d. None of the professional employees or partners at either office.
27. The purpose of segregating the duties of distributing payroll checks and hiring personnel is to separate the
a. Duties within the accounting function.
b. Custody of assets from the accounting for those assets.
c. Authorization of transactions from the custody of related assets.
d. Operational responsibility from record keeping responsibility.

28. If the perpetual inventory records show lower quantities of inventory than the physical count, an explanation of the difference might be unrecorded
a. Sales.
b. Sales discounts.
c. Purchases.
d. Purchase discounts.

29. In estimation sampling for variables, which of the following must be known in order to estimate the appropriate sample size required to meet the auditor’s needs in a given situation?
a. The qualitative aspects of errors.
b. The total dollar amount of the population.
c. The acceptable level of risk.
d. The estimated rate of error in the population.

30. When an independent auditor reports on internal accounting control based on criteria established by governmental agencies, the report should
a. Not include the agency’s name in the report.
b. Indicate matters covered by the study and whether the auditor’s study included tests of compliance with the procedures covered by the study.
c. Not express a conclusion based on the agency’s criteria.
d. Assume responsibility for the comprehensiveness of the criteria established by the agency and include recommendations for corrective action.

31. The most important function of generalized audit software is the capability to
a. Access information stored on computer files.
b. Select a sample of items for testing.
c. Evaluate sample test results.
d. Test the accuracy of the client’s calculations.

32. When testing a computerized accounting system, which of the following is not true of the test data approach?
a. The test data need consist of only those valid and invalid conditions in which the auditor is interested.
b. Only one transaction of each type need be tested.
c. Test data are processed by the client’s computer programs under the auditor’s control.
d. The test data must consist of all possible valid and invalid conditions.

33. If an auditor has not gathered sufficient evidential matter to support the management assertions that are embodied in the financial statements, the auditor may either issue
a. Disclaimer of opinion or “except for” qualified opinion.
b. Adverse opinion or disclaimer of opinion.
c. Adverse opinion or “except for” qualified opinion.
d. Disclaimer of opinion or “subject to” qualified opinion.

34. When counting cash on hand the auditor must exercise control over all cash and other negotiable assets to prevent
a. Theft.
b. Irregular endorsement.
c. Substitution.
d. Deposits-in-transit.

35. Which of the following is not one of the independent auditor’s objectives regarding the examination of inventories?
a. Verifying that inventory counted is owned by the client.
b. Verifying that the client has used proper inventory pricing.
c. Ascertaining the physical quantities of inventory on hand.
d. Verifying that all inventory owned by the client is on hand at the time of the count.

36. Which of the following statements concerning the independent auditor’s required communication of material weaknesses in internal accounting controls is correct?
a. Weaknesses reported at interim dates must be repeated in the final communication.
b. If the auditor does not become aware of any material weaknesses during the examination, that fact must be communicated.
c. Weaknesses that had been reported in prior years’ communications and have not been corrected need not be repeated in the current year’s communication.
d. Although written communication is preferable, the auditor may communicate the findings orally.

37. If the independent auditors decide that the work performed by the internal auditor may have a bearing on their own procedures, they should consider the internal auditor’s
a. Competence and objectivity.
b. Efficiency and experience.
c. Independence and review skills.
d. Training and supervisory skills.
Items 38 and 39 are based on the following information:

The diagram below depicts the auditor’s estimated deviation rate compared with the tolerable rate, and also depicts the true population deviation rate compared with the tolerable rate.

<table>
<thead>
<tr>
<th>True State of Population</th>
<th>Deviation Rate</th>
<th>Deviation Rate</th>
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<tbody>
<tr>
<td></td>
<td>Exceeds Tolerable Rate</td>
<td>is Less Than Tolerable Rate</td>
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<tr>
<td><strong>Auditor’s Estimate Based On Sample Results</strong></td>
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<td></td>
</tr>
<tr>
<td>Deviation Rate Exceeds Tolerable Rate</td>
<td>I.</td>
<td>II.</td>
</tr>
<tr>
<td>Deviation Rate is Less Than Tolerable Rate</td>
<td>III.</td>
<td>IV.</td>
</tr>
</tbody>
</table>

38. In which of the situations would the auditor have properly relied on internal control?
   a. I.
   b. II.
   c. III.
   d. IV.

39. As a result of compliance testing, the auditor under- relies on internal accounting control and thereby increases substantive testing. This is illustrated by situation
   a. I.
   b. II.
   c. III.
   d. IV.

40. The existence of a related party transaction may be indicated when another entity
   a. Sells real estate to the corporation at a price that is comparable to its appraised value.
   b. Absorbs expenses of the corporation.
   c. Borrows from the corporation at a rate of interest which equals the current market rate.
   d. Lends to the corporation at a rate of interest which equals the current market rate.

41. Smith is engaged in the audit of a cable TV firm which serves a rural community. All receivable balances are small, customers are billed monthly, and internal control is effective. To determine the validity of the accounts receivable balances at the balance sheet date, Smith would most likely
   a. Send positive confirmation requests.
   b. Send negative confirmation requests.
   c. Examine evidence of subsequent cash receipts instead of sending confirmation requests.
   d. Use statistical sampling instead of sending confirmation requests.

42. To test for unsupported entries in the ledger, the direction of audit testing should be from the
   b. Ledger entries.
   c. Original source documents.
   d. Externally generated documents.

43. Which of the following procedures is least likely to be performed before the balance sheet date?
   a. Confirmation of receivables.
   b. Search for unrecorded liabilities.
   c. Observation of inventory.
   d. Review of internal accounting control over cash disbursements.

44. Which of the following is least likely to include a reference to the use of a specialist?
   a. Unqualified opinion.
   b. Adverse opinion.
   c. “Except for” qualified opinion.
   d. “Subject to” qualified opinion.

45. Which of the following is not an audit procedure which the independent auditor would perform with respect to litigation, claims, and assessments?
   a. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
   b. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the balance sheet date.
   c. Obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed.
   d. Confirm directly with the client’s lawyer that all claims have been recorded in the financial statements.

46. To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should consider all of the following except
   a. Tolerable error.
   b. Deviation rate.
   c. Allowable risk of incorrect acceptance.
   d. Characteristics of the population.
47. Which of the following would provide the best form of evidential matter pertaining to the annual valuation of a long-term investment in which the independent auditor's client owns a 30% voting interest?
   a. Market quotations of the investee company’s stock.
   b. Current fair value of the investee company’s assets.
   c. Historical cost of the investee company’s assets.
   d. Audited financial statements of the investee company.

48. The size of a sample designed for dual purpose testing should be
   a. The larger of the samples that would otherwise have been designed for the two separate purposes.
   b. The smaller of the samples that would otherwise have been designed for the two separate purposes.
   c. The combined total of the samples that would otherwise have been designed for the two separate purposes.
   d. More than the larger of the samples that would otherwise have been designated for the two separate purposes, but less than the combined total of the samples that would otherwise have been designed for the two separate purposes.

49. Which of the following statements about working papers is correct?
   a. Working papers are not permitted to be used as a reference source by the client.
   b. Documentation of an auditor’s understanding of client’s internal accounting control system may not be necessary.
   c. Working papers may be regarded as a substitute for the client’s accounting records.
   d. When reporting on comparative financial statements the independent auditor may discard working papers after two years.

50. A primary purpose of an operational audit is to provide
   a. The results of internal examinations of financial and accounting matters to a company’s top-level management.
   b. A measure of management performance in meeting organizational goals.
   c. A means of assurance that internal accounting controls are functioning as planned.
   d. Aid to the independent auditor, who is conducting the examination of the financial statements.

51. When auditing “around” the computer, the independent auditor focuses solely upon the source documents and
   a. Test data.
   b. EDP processing.
   c. Compliance techniques.
   d. EDP output.

52. What type of EDP system is characterized by data that are assembled from more than one location and records that are updated immediately?
   a. Microcomputer system.
   b. Minicomputer system.
   c. Batch processing system.
   d. Online real-time system.

53. Restrictions imposed by the client, Rex Company, prohibit the confirmation of accounts receivable by direct communication with debtors. These receivables account for 30% of all assets and alternative audit procedures cannot be applied, although the independent auditor was able to examine satisfactory evidence for all other items in the financial statements. The independent auditor should issue a (an)
   a. Disclaimer of opinion.
   b. Adverse opinion.
   c. “Subject to” qualified opinion.
   d. “Except for” qualified opinion.

54. If an auditor dates the auditor’s report on financial statements for the year ended December 31, 1984, as of February 10, 1985, except for Note J, as to which the date is March 3, 1985, the auditor is taking responsibility for
   a. All subsequent events occurring through March 3, 1985.
   b. All subsequent events occurring through February 10, 1985 only.
   c. All subsequent events occurring through February 10, 1985, and the specific subsequent event referred to in Note J through March 3, 1985.
   d. Only the specific subsequent event referred to in Note J through March 3, 1985.

55. The independent auditor has concluded that a substantial doubt remains about a client’s ability to continue in existence, but the client’s financial statements have properly disclosed all of its solvency problems. The auditor would probably issue a (an)
   a. Unqualified opinion with appropriate reference to the middle paragraph.
   b. “Except for” qualified opinion.
   c. “Subject to” qualified opinion.
   d. Adverse opinion.

56. A public entity that is required to present information on the effects of changing prices pursuant to FASB statement No. 33 does not present the effects of changing prices in its annual report. The auditors have decided to issue the standard scope paragraph and include a separate paragraph in the auditors’ report that will call attention to the omission of the effects of changing prices required by the FASB. Assuming no other problems exist, the auditors should express a (an)
   a. Unqualified opinion.
   b. “Subject to” qualified opinion.
   c. Adverse opinion.
   d. “Except for” qualified opinion.
57. The independent auditors for Louis, Inc., a publicly held company, conclude that their omission of an audit procedure considered necessary at the time of the examination impairs their present ability to support the previously expressed opinion. If they believe there are persons currently relying on the report, they should promptly
   a. Undertake to apply the omitted procedure or alternate procedures that would provide a satisfactory basis for the opinion.
   b. Notify the board of directors that the previously expressed opinion is not to be relied upon.
   c. Notify the stockholders currently relying on the report that the previously expressed opinion is not to be relied upon.
   d. Notify the Securities and Exchange Commission that the previously expressed opinion is not to be relied upon.

58. The report of a CPA on a review of the financial statements of a nonpublic entity should not include a statement that
   a. All information included in the financial statements is the representation of the owners of the entity.
   b. The review was performed in accordance with generally accepted auditing standards.
   c. The CPA is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles.
   d. A review consists principally of inquiries of company personnel and analytical procedures applied to financial data.

59. After properly communicating with the predecessor auditor, Seal & Co., CPAs, accepted the engagement to audit Mass Company's annual financial statements. Mass desires that comparative statements from years audited by the predecessor auditor be presented in the annual report. The predecessor auditor's report will not be presented. What effect would inclusion of such comparative financial statements have on the auditors' report of Seal?
   a. Seal should make no reference to the report of the predecessor auditor in the scope paragraph.
   b. Seal should make reference to the report of the predecessor auditor in both the scope and opinion paragraphs.
   c. Seal should make reference to the report of the predecessor auditor in the opinion paragraph only.
   d. Seal should make no reference to the report of the predecessor auditor in the opinion paragraph.

60. Which of the following symbolic representations indicates that a sales invoice has been filed?
   a. 
   b. 
   c. 
   d. 

A-94
Auditing

Number 2 (Estimated time — 15 to 25 minutes)

The CPA firm of May & Marty has audited the consolidated financial statements of BGI Corporation. May & Marty performed the examination of the parent company and all subsidiaries except for BGI-Western Corporation, which was audited by the CPA firm of Dey & Dee. BGI-Western constituted approximately 10% of the consolidated assets and 6% of the consolidated revenue. Dey & Dee issued an unqualified opinion on the financial statements of BGI-Western. May & Marty will be issuing an unqualified opinion on the consolidated financial statements of BGI.

Required:

a. What procedures should May & Marty consider performing with respect to Dey & Dee's examination of BGI-Western's financial statements that will be appropriate whether or not reference is to be made to the other auditors?

b. Describe the various circumstances under which May & Marty could take responsibility for the work of Dey & Dee and make no reference to Dey & Dee's examination of BGI-Western in May & Marty's auditor's report on the consolidated financial statements of BGI.

Number 3 (Estimated time — 15 to 25 minutes)

On March 12, 1985, Brown & Brown, CPAs, completed the audit engagement of the financial statements of Modern Museum, Inc., for the year ended December 31, 1984. Modern Museum presents comparative financial statements on a modified cash basis. Assets, liabilities, fund balances, support, revenues, and expenses are recognized when cash is received or disbursed, except that Modern includes a provision for depreciation of buildings and equipment. Brown & Brown believes that Modern's three financial statements, prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, are adequate for Modern's needs and wishes to issue an auditor's special report on the financial statements. Brown & Brown has gathered sufficient competent evidential matter in order to be satisfied that the financial statements are fairly presented according to the modified cash basis. Brown & Brown audited Modern's 1983 financial statements and issued the auditor's special report expressing an unqualified opinion.

Required:

Draft the auditors’ report to accompany Modern's comparative financial statements.

Number 4 (Estimated time — 15 to 25 minutes)

The CPA firm of Wright & Co. is in the process of examining William Corporation's 1984 financial statements. The following open matters must be resolved before the audit can be completed:

1. No audit work has been performed on nonresponses to customer accounts receivable confirmation requests. Both positive and negative confirmations were used. A second request was sent to debtors who did not respond to the initial positive request.

2. The client representation letter has not been completed and signed by William's management. Wright has started to outline the content of the representation letter and believes the following matters should be included in the letter: Management should acknowledge whether or not

   • All material transactions have been properly reflected in the financial statements.
   • It is aware of irregularities that could have a material effect on the financial statements or that involve management or employees.
   • Events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.
   • There are any communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
   • The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
   • There are any plans or intentions that may materially affect the carrying value or classification of assets or liabilities.
   • There are any losses from sales commitments.
   • There are any losses from purchase commitments for inventory quantities in excess of requirements or at prices in excess of market.
   • There are any agreements to repurchase assets previously sold.
   • There are any violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
   • There are any capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

Required:

a. What alternative audit procedures should Wright consider performing on the nonresponses to customer accounts receivable confirmation requests?

b. Identify the other matters that Wright would expect to be included in William's management representation letter.
Number 5 (Estimated time —— 15 to 25 minutes)

In 1984 XY Company purchased over $10 million of office equipment under its "special" ordering system, with individual orders ranging from $5,000 to $30,000. "Special" orders entail low volume items which have been included in an authorized user's budget. Department heads include in their annual budget requests the types of equipment and their estimated cost. The budget, which limits the types and dollar amounts of office equipment a department head can requisition, is approved at the beginning of the year by the board of directors. Department heads prepare a purchase requisition form for equipment and forward the requisition to the purchasing department. XY's "special" ordering system functions as follows:

Purchasing: Upon receiving a purchase requisition, one of five buyers verifies that the person requesting the equipment is a department head. The buyer then selects the appropriate vendor by searching the various vendor catalogs on file. The buyer then phones the vendor, requesting a price quotation, and gives the vendor a verbal order. A prenumbered purchase order is then processed with the original sent to the vendor, a copy to the department head, a copy to receiving, a copy to accounts payable, and a copy filed in the open requisition file. When the buyer is orally informed by the receiving department that the item has been received, the buyer transfers the purchase order from the unfilled file to the filled file. Once a month the buyer reviews the unfilled file to follow up and expedite open orders.

Receiving: The receiving department receives a copy of the purchase order. When equipment is received the receiving clerk stamps the purchase order with the date received, and, if applicable, in red pen prints any differences between quantity on the purchase order and quantity received. The receiving clerk forwards the stamped purchase order and equipment to the requisitioning department head and orally notifies the purchasing department.

Accounts payable: Upon receipt of a purchase order, the accounts payable clerk files the purchase order in the open purchase order file. When a vendor invoice is received, the invoice is matched with the applicable purchase order, and a payable is set up by debiting the equipment account of the department requesting the items. Unpaid invoices are filed by due date and, at due date, a check is prepared. The invoice and purchase order are filed by purchase order number in a paid invoice file, and then the check is forwarded to the treasurer for signature.

Treasurer: Checks received daily from the accounts payable department are sorted into two groups: those over $10,000 and those $10,000 and less. Checks for $10,000 and less are machine-signed. The cashier maintains the key and signature plate to the check-signing machine, and maintains a record of usage of the check-signing machine. All checks over $10,000 are signed by the treasurer or the controller.

Required:

Describe the internal accounting control weaknesses relating to purchases and payments of "special" orders of XY Company for each of the following functions:

a. Purchasing,
b. Receiving,
c. Accounts payable, and
d. Treasurer.
ANSWERS TO EXAMINATION

AUDITING

November 7, 1985; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. c 11. a 21. c 31. a 41. b 51. d
2. c 12. a 22. d 32. d 42. b 52. d
3. d 13. c 23. d 33. a 43. b 53. a
4. b 14. a 24. b 34. c 44. a 54. c
5. d 15. b 25. c 35. d 45. d 55. c
6. a 16. c 26. b 36. d 46. b 56. a
7. d 17. c 27. c 37. a 47. d 57. a
8. d 18. b 28. c 38. d 48. a 58. b
9. a 19. c 29. c 39. b 49. b 59. d
10. b 20. a 30. b 40. b 50. b 60. d

The scores for the multiple choice questions were determined in accordance with the following scale:

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Answer 2  (10 points)

a. In order for May & Marty to satisfy itself about the independence and professional reputation of Dey & Dee and assure itself that there has been coordination of activities between the two auditors in order to achieve a proper review of matters affecting consolidation, May & Marty, whether or not it makes reference to Dey & Dee's examination, should consider performing the following procedures:

- Make inquiries about the professional reputation and standing of Dey & Dee to one or more of the following:
  - AICPA, applicable state society of CPAs, and/or local chapter.
  - Other appropriate sources such as other practitioners, bankers, and other credit grantors.
- Obtain a representation from Dey & Dee that it is independent under the requirements of the AICPA and, if appropriate, the requirements of the SEC.
- Ascertain through communication with Dey & Dee that
  - Dey & Dee is aware that the BGI-Western financial statements are to be included in the BGI consolidated financial statements on which May & Marty will report, and that Dey & Dee's report will be relied upon by May & Marty.
  - Dey & Dee is familiar with GAAP and GAAS and will conduct its examination in accordance therewith.
  - Dey & Dee has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the SEC, if appropriate.
  - A review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among components included in the financial statements.

b. May & Marty could adopt the position of not making reference to Dey & Dee's examination of BGI-Western if May & Marty is able to satisfy itself about the independence and professional reputation of Dey & Dee and takes steps it considers appropriate to satisfy itself as to Dey & Dee's examination of BGI-Western. Ordinarily, May & Marty would be able to adopt the position of not making reference to Dey & Dee's examination when any one of the following conditions exists:

- Dey & Dee is an associate or correspondent firm and its work is acceptable to May & Marty based on May & Marty's knowledge of the professional standards and competence of Dey & Dee; or
- Dey & Dee is retained by May & Marty and the work is performed under May & Marty's guidance and control; or
- May & Marty takes steps it considers necessary to satisfy itself as to Dey & Dee's examination. Such steps may include a visit to Dey and Dee to discuss Dey and Dee's audit procedures or a review of Dey and Dee's audit programs and/or working papers. In addition, May and Marty is satisfied about the reasonableness of the statements of BGI-Western for purposes of inclusion in BGI's consolidated financial statements; or
- BGI-Western's financial statements are not a material part of BGI's consolidated financial statements.
Answer 3  (10 points)

To the Board of Trustees of
Modern Museum, Inc.

We have examined the statements of assets, liabilities, and fund balances (modified cash basis) of Modern Museum, Inc., as of December 31, 1984 and 1983, and the related statements of support, revenue, and expenses and of changes in fund balances (modified cash basis) and changes in financial resources (modified cash basis) for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note X, the organization's policy is to prepare its financial statements on the basis of cash receipts and disbursements, except that they include provision for depreciation of buildings and equipment. Consequently, certain revenue and the related assets are recognized when received rather than when earned, and certain expenses are recognized when paid rather than when the obligation is incurred. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the assets, liabilities, and fund balances of Modern Museum, Inc., at December 31, 1984 and 1983, and its support, revenue, and expenses and the changes in its fund balances and changes in financial resources for the years then ended, on the basis of accounting described in Note X, which has been applied on a consistent basis.

Brown & Brown, CPAs

March 12, 1985

Answer 4  (10 points)

a. Since recipients of negative accounts receivable confirmations are requested to respond only if they disagree with the information in the confirmation, no additional audit procedures are necessary on nonresponses to negative accounts receivable confirmations.

For nonresponses to positive confirmations, Wright should consider performing the following alternative audit procedures:

• The use of other means, e.g., telephone inquiry, of directly communicating with the debtor.
• Examination of evidence of subsequent cash receipts.
• Examination of evidence of customer orders, duplicate sales invoices, and shipping documents.
• Examination of William's files involving correspondence with the customers.

b. The other matters that Wright would expect to be included in William's management representation letter are whether or not

• Management acknowledges responsibility for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (or other comprehensive basis of accounting).
• All financial records and data were made available.
• The accountant has been furnished with copies of all minutes of meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies).
• The company has satisfactory title to all owned assets, and whether there are liens or encumbrances on such assets or any pledging of assets.
• Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.
• There are related party transactions or related party receivables or payables that have not been properly disclosed in the financial statements.
• There are compensating balances or other arrangements involving restrictions on cash balances.
• Unasserted claims or assessments that management's counsel has advised are probable of assertion have been disclosed in accordance with Statement of Financial Accounting Standards No. 5.
• There are other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.
Answer 5 (10 points)

XY Company's major internal accounting control weaknesses are:

**Purchasing:**
- The buyer does not verify that the department head's request is within budget limitations.
- No procedures have been established to assure that the best price is obtained. Large dollar requisitions should be ordered after receiving quotes and/or sealed bids.
- Prior to placing an order, the buyer does not determine the adequacy of the vendor's past record as a supplier to XY.

**Receiving:**
- Receiving clerk does not make blind counts for all special equipment or at least for large dollar items.
- Written notice of equipment received is not sent to purchasing.
- Written notice of equipment received is not sent to accounts payable.

**Accounts Payable:**
- The mathematical accuracy of the invoice is not recomputed.
- Invoice quantity is not compared with a report of quantity received.
- Notification of the acceptability of the equipment from the requisitioning department is not obtained before the payable is recorded.
- No alphabetic file of vendors from whom purchases are made is maintained.

**Treasurer:**
- Documentation supporting the checks is not sent by the accounts payable department to the cashier in order for the cashier or treasurer to be assured that the check is for properly authorized and received equipment.
- Checks for large dollar purchases are not signed by two officers of XY Company to assure that material expenditures are proper.
- All documentation to support a check is not canceled by the check-signer and returned to the accounts payable department.
- The cashier alone has custody of the key, the signature plate, and record of usage.
- The controller is authorized to sign checks.
SUGGESTED REFERENCES

November 1985

Auditing

Number 1


AICPA, Codification of Statements on Auditing Standards Nos. 1 to 49 (Commerce Clearing House, 1985).


AICPA, Professional Standards, Auditing, Management Advisory Services, Tax Practice, Accounting and Review Services, vol. 1 (Commerce Clearing House).

AICPA, Professional Standards, Ethics, Bylaws, Quality Control, vol. 2 (Commerce Clearing House).


Cook and Winkle, Auditing, 3d ed. (Houghton Mifflin, 1984).

Davis, Adams, and Schaller, Auditing and EDP, 2d ed. (AICPA, 1983).

Defliese, Jaenicke, Sullivan and Gnospelius; Montgomery’s Auditing, 10th ed. (Wiley, 1984).


Ricchiute, Auditing Concepts and Standards (Southwestern, 1982).


Number 2

AICPA, Codification of Statements on Auditing Standards Nos. 1 to 49 (Commerce Clearing House, 1985), section 543.

AICPA, Codification of Statements on Auditing Standards Nos. 1 to 49 (Commerce Clearing House, 1985), section 621.


Number 4

AICPA, Codification of Statements on Auditing Standards Nos. 1 to 49 (Commerce Clearing House, 1985), sections 331 and 333.


Number 5


INDEX — QUESTIONS

HOW TO USE THIS INDEX: This index presents examination question number references according to the areas and groups within the Auditing Content Specification Outline. The Appendix located at the back of this book contains the content specification outlines for the four sections of the CPA examination.

The question references listed in the right hand column are designated as follows. The question numbers are followed by the page number (in parentheses) in this book. The letter M following question numbers indicates a multiple choice item. For example, the reference 17M(AP-250) means multiple choice item number 17 on page AP-250, the reference 5(AP-258) means essay or problem number 5 on page AP-258. Note that no distinction has been made between Accounting Practice, Parts I and II.

Auditing — Content Specification Outline

I. Professional Responsibilities.
   B. Control of the Audit .............................................3M(A-88),9M(A-89),10M(A-89)

II. Internal Control.
   A. Definitions and Basic Concepts .........................16M(A-89),21M(A-90),37M(A-91)

III. Evidence and Procedures.
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   D. Review and Compilation Procedures ......................

IV. Reporting.
   B. Other Reporting Considerations .............................56M(A-93),2(A-95)
Business Law

Selected Questions
And Unofficial Answers
Indexed To
Content Specification Outline

edited by
James D. Blum
Assistant Director, Examinations Division
Mark S. Goldstein
Technical Manager, Examinations Division
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* No essays were indexed for this group.
† Questions in this area are not classified according to group.
Selected Questions

VII. Property
   A. Real and Personal Property
   B. Mortgages
   C. Fire and Casualty Insurance

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Suggested References B-123
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MULITPLE CHOICE ITEMS — SELECTED QUESTIONS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons

N84#1. In a common law action against an accountant, the lack of privity is a viable defense if the plaintiff
a. Bases his action upon fraud.
b. Is the accountant’s client.
c. Is a creditor of the client who sues the accountant for negligence.
d. Can prove the presence of gross negligence which amounts to a reckless disregard for the truth.

N84#2. Rhodes Corp. desired to acquire the common stock of Harris Corp. and engaged Johnson & Co., CPAs, to audit the financial statements of Harris Corp. Johnson failed to discover a significant liability in performing the audit. In a common law action against Johnson, Rhodes at a minimum must prove
a. Gross negligence on the part of Johnson.
b. Negligence on the part of Johnson.
c. Fraud on the part of Johnson.
d. Johnson knew that the liability existed.

N84#3. To recover in a common law action based upon fraud against a CPA with regard to an audit of financial statements, the plaintiff must prove among other things
a. Privity of contract.
b. Unavailability of any other cause of action.
c. That there was a sale or purchase of securities within a six month period that resulted in a loss.
d. Reliance on the financial statements.

N84#6. Dexter and Co., CPAs, issued an unqualified opinion on the 1983 financial statements of Bart Corp. Late in 1984, Bart determined that its treasurer had embezzled over $1,000,000. Dexter was unaware of the embezzlement. Bart has decided to sue Dexter to recover the $1,000,000. Bart’s suit is based upon Dexter’s failure to discover the missing money while performing the audit. Which of the following is Dexter’s best defense?
   a. That the audit was performed in accordance with GAAS.
   b. Dexter had no knowledge of the embezzlement.
   c. The financial statements were presented in conformity with GAAP.
   d. The treasurer was Bart’s agent and as such had designed the internal controls which facilitated the embezzlement.

N84#7. If a stockholder sues a CPA for common law fraud based upon false statements contained in the financial statements audited by the CPA, which of the following is the CPA’s best defense?
   a. The stockholder lacks privity to sue.
   b. The CPA disclaimed liability to all third parties in the engagement letter.
   c. The contributory negligence of the client.
   d. The false statements were immaterial.

N83#1. Locke, CPA, was engaged by Hall, Inc., to audit Willow Company. Hall purchased Willow after receiving Willow’s audited financial statements, which included Locke’s unqualified auditor’s opinion. Locke was negligent in the performance of the Willow audit engagement. As a result of Locke’s negligence, Hall suffered damages of $75,000. Hall appears to have grounds to sue Locke for

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N83#2. In which of the following statements concerning a CPA firm’s action is scienter or its equivalent absent?
   a. Reckless disregard for the truth.
   b. Actual knowledge of fraud.
   c. Intent to gain monetarily by concealing fraud.
   d. Performance of substandard auditing procedures.

N83#3. Gleam is contemplating a common law action against Moore & Co., CPAs, based upon fraud. Gleam loaned money to Lilly & Company relying upon Lilly's
financial statements which were audited by Moore. Gleam's action will fail if
a. Gleam shows only that Moore failed to metic-
   ulously follow GAAP.
b. Moore can establish that they fully complied
   with the Statute of Frauds.
c. The alleged fraud was in part committed by
   oral misrepresentations and Moore pleads the
   parol evidence rule.
d. Gleam is not a third party beneficiary in light
   of the absence of privity.

N83#4. In an action for negligence against a CPA, “the custom of the profession” standard is used at least
   to some extent in determining whether the CPA is neg-
   ligent. Which of the following statements describes how
   this standard is applied?
a. If the CPA proves he literally followed
   GAAP and GAAS, it will be conclusively pre-
   sumed that the CPA was not negligent.
b. The custom of the profession argument may
   only be raised by the defendant.
c. Despite a CPA’s adherence to the custom of
   the profession, negligence may nevertheless be present.
d. Failure to satisfy the custom of the profession is equivalent to gross negligence.

M81#1. DMO Enterprises, Inc., engaged the account-
   ing firm of Martin, Seals & Anderson to perform its
   annual audit. The firm performed the audit in a com-
   petent, nonnegligent manner and billed DMO for
   $16,000, the agreed fee. Shortly after delivery of the
   audited financial statements, Hightower, the assistant
   controller, disappeared, taking with him $28,000 of
   DMO’s funds. It was then discovered that Hightower
   had been engaged in a highly sophisticated, novel de-
   falcation scheme during the past year. He had previ-
   ously embezzled $35,000 of DMO funds. DMO has
   refused to pay the accounting firm’s fee and is seeking
   to recover the $63,000 that was stolen by Hightower. Which of the following is correct?
a. The accountants can not recover their fee and
   are liable for $63,000.
b. The accountants are entitled to collect their
   fee and are not liable for $63,000.
c. DMO is entitled to rescind the audit contract
   and thus is not liable for the $16,000 fee, but it
   can not recover damages.
d. DMO is entitled to recover the $28,000 de-
   falcation, and is not liable for the $16,000 fee.

M81#6. If a CPA firm is being sued for common law
fraud by a third party based upon materially false fin-
ancial statements, which of the following is the best
defense which the accountants could assert?
a. Lack of privity.
b. Lack of reliance.
c. A disclaimer contained in the engagement let-
ter.
d. Contributory negligence on the part of the client.

B. Federal Statutory Liability

N84#4. Doe and Co., CPAs, issued an unqualified opinion on the 1983 financial statements of Marx Corp. These financial statements were included in Marx’s annual report and form 10K filed with the SEC. Doe did not detect material misstatements in the financial statements as a result of negligence in the performance of the audit. Based upon the financial statements, Fitch purchased stock in Marx. Shortly thereafter, Marx became insolvent, causing the price of the stock to decline drastically. Fitch has commenced legal action against Doe for damages based upon section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934. Doe’s best defense to such an action would be that
a. Fitch lacks privity to sue.
b. The engagement letter specifically disclaimed
   all liability to third parties.
c. There is no proof of scienter.
d. There has been no subsequent sale for which
   a loss can be computed.

N84#5. Hall purchased Eon Corp. bonds in a public offering subject to the Securities Act of 1933. Kosson
and Co., CPAs, rendered an unqualified opinion on Eon’s financial statements, which were included in
Eon’s registration statement. Kosson is being sued by Hall based upon misstatements contained in the financial
statements. In order to be successful, Hall must prove

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<td>a.</td>
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N84#9. A preparer of a tax return may incur penalties
under the Internal Revenue Code in all of the following cases except where the taxpayer
a. Substantially overvalues property donated to
   a charitable organization.
b. Claims a substantial deduction for unpaid ex-
   penses incurred by the cash basis taxpayer.
c. Claims a substantial deduction for a loss re-
   sulting from an accidental fire.
d. Takes a position at variance with the Internal
   Revenue Code and a U.S. Supreme Court
   decision on the specific point.

N84#10. Alex Stone, CPA, prepared Ray Pym’s 1983 federal income tax return. Pym advised Stone that he
had paid doctors’ bills of $15,000 during 1983, when in fact Pym had paid only $3,000 of bills. Based on Pym’s repres-
sentations, Stone properly computed the medical expense deduction, with consequent understatement of
tax liability of more than $5,000. Pym’s total tax liability
shown on the return was $40,000. Stone had no reason
to doubt the accuracy of Pym’s figures, although Stone
did not request documentation for the expenses
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claimed; but he was assured by Pym that sufficient corrobative evidence of these expenses existed. In connection with Stone's preparation of Pym's 1983 return, Stone is

   a. Not subject to any IRS penalty or interest.
   b. Not subject to any IRS penalty, but is liable for interest on the underpayment of tax.
   c. Subject to the negligence penalty.
   d. Subject to the penalty for willful understatement of tax liability.

N83#5. Lewis & Clark, CPAs, rendered an unqualified opinion on the financial statements of a company that sold common stock in a public offering subject to the Securities Act of 1933. Based on a false statement in the financial statements, Lewis & Clark are being sued by an investor who purchased shares of this public offering. Which of the following represents a viable defense?

   a. The investor has not met the burden of proving fraud or negligence by Lewis & Clark.
   b. The investor did not actually rely upon the false statement.
   c. Detection of the false statement by Lewis & Clark occurred after their examination date.
   d. The false statement is immaterial in the overall context of the financial statements.

N83#6. The Internal Revenue Code provisions dealing with tax return preparation

   a. Require tax return preparers who are neither attorneys nor CPAs to pass a basic qualifying examination.
   b. Apply to all tax return preparers whether they are compensated or uncompensated.
   c. Apply to a CPA who prepares the tax returns of the president of a corporation the CPA audits, without charging the president.
   d. Only apply to preparers of individual tax returns.

N83#7. Georges, a CPA, has prepared a tax return for his client, Arbor. The return was prepared in a fraudulent manner. Regarding Georges's potential liability to various parties, which of the following would be dismissed?

   a. A federal criminal action.
   b. A federal action for civil penalties.
   c. A federal action to revoke Georges's CPA certificate.
   d. A malpractice action by the client.

N83#8. Gibson is suing Simpson & Sloan, CPAs, to recover losses incurred in connection with Gibson's transactions in Zebra Corporation securities. Zebra's Annual Form 10-K Report contained material false and misleading statements in the financial statements audited by Simpson & Sloan. To recover under the Securities and Exchange Act of 1934, Gibson must, among other things, establish that

   a. All of his past transactions in Zebra securities, both before and after the auditors' report date, resulted in a net loss.
   b. The transaction in Zebra securities that resulted in a loss occurred within 90 days of the auditors' report date.
   c. He relied upon the financial statements in his decision to purchase or sell Zebra securities.
   d. The market price of the stock dropped significantly after corrected financial statements were issued by Zebra.

M81#3. Major, Major & Sharpe, CPAs, are the auditors of MacLain Industries. In connection with the public offering of $10 million of MacLain securities, Major expressed an unqualified opinion as to the financial statements. Subsequent to the offering, certain misstatements and omissions were revealed. Major has been sued by the purchasers of the stock offered pursuant to the registration statement which included the financial statements audited by Major. In the ensuing lawsuit by the MacLain investors, Major will be able to avoid liability if

   a. The errors and omissions were caused primarily by MacLain.
   b. It can be shown that at least some of the investors did not actually read the audited financial statements.
   c. It can prove due diligence in the audit of the financial statements of MacLain.
   d. MacLain had expressly assumed any liability in connection with the public offering.

M81#4. Donalds & Company, CPAs, audited the financial statements included in the annual report submitted by Markum Securities, Inc., to the Securities and Exchange Commission. The audit was improper in several respects. Markum is now insolvent and unable to satisfy the claims of its customers. The customers have instituted legal action against Donalds based upon section 10b and rule 10b-5 of the Securities Exchange Act of 1934. Which of the following is likely to be Donalds' best defense?

   a. They did not intentionally certify false financial statements.
   b. Section 10b does not apply to them.
   c. They were not in privity of contract with the creditors.
   d. Their engagement letter specifically disclaimed any liability to any party which resulted from Markum's fraudulent conduct.

C. Workpapers, Privileged Communication, and Confidentiality

N84#8. The accountant-client privilege

   a. May not be waived by either the accountant or the client.
   b. Is intended to protect full and honest disclosure between accountant and client.
   c. Is as widely recognized as the attorney-client privilege.
   d. Only applies to written documents.
N83#9. With respect to privileged communications of accountants, which of the following is correct?
   a. A state statutory privilege will be recognized in a case being tried in a federal court involving a federal question.
   b. Most courts recognize a common-law privilege between an accountant and the client.
   c. As a result of legislative enactment and court adoption, the client-accountant privilege is recognized in the majority of jurisdictions.
   d. The privilege will be lost if the party asserting the privilege voluntarily submits part of the privileged communications into evidence.

N83#10. Working papers prepared by a CPA in connection with an audit engagement are owned by the CPA, subject to certain limitations. The rationale for this rule is to
   a. Protect the working papers from being subpoenaed.
   b. Provide the basis for excluding admission of the working papers as evidence because of the privileged communication rule.
   c. Provide the CPA with evidence and documentation which may be helpful in the event of a lawsuit.
   
   d. Establish a continuity of relationship with the client whereby indiscriminate replacement of CPAs is discouraged.

M81#2. The CPA firm of Knox & Knox has been subpoenaed to testify and produce its correspondence and workpapers in connection with a lawsuit brought by a third party against one of their clients. Knox considers the subpoenaed documents to be privileged communication and therefore seeks to avoid admission of such evidence in the lawsuit. Which of the following is correct?
   a. Federal law recognizes such a privilege if the accountant is a Certified Public Accountant.
   b. The privilege is available regarding the working papers since the CPA is deemed to own them.
   c. The privileged communication rule as it applies to the CPA-client relationship is the same as that of attorney-client.
   d. In the absence of a specific statutory provision, the law does not recognize the existence of the privileged communication rule between a CPA and his client.

II. Business Organizations

A. Agency

M85#1. Wok Corp. has decided to expand the scope of its business. In this connection, it contemplates engaging several agents. Which of the following agency relationships is within the statute of frauds and thus should be contained in a signed writing?
   a. A sales agency where the agent normally will sell goods which have a value in excess of $500.
   b. An irrevocable agency.
   c. An agency which is of indefinite duration but which is terminable upon one month’s notice.
   d. An agency for the forthcoming calendar year which is entered into in mid-December of the prior year.

M85#2. Red entered into a contract with Maple on behalf of Gem, a disclosed principal. Red exceeded his authority in entering into the contract. In order for Gem to successfully ratify the contract with Maple,
   a. Gem must expressly communicate his intention to be bound.
   b. Gem must have knowledge of the relevant material facts concerning the transaction.
   c. Red must not have been a minor.
   d. Red must have acted reasonably and in Gem’s best interest.

M85#3. An agency coupled with an interest will be created by a written agreement which provides that a(an)
   a. Borrower shall pledge securities to a lender which authorizes the lender to sell the securities and apply the proceeds to the loan in the event of default.
   b. Employee is hired for a period of two years at $40,000 per annum plus 2% of net sales.
   c. Broker is to receive a 5% sales commission out of the proceeds of the sale of a parcel of land.
   d. Attorney is to receive 25% of a plaintiff’s recovery for personal injuries.

M85#4. Baker Corp. dismissed Abel as its general sales agent. Baker notified all of Abel’s known customers by letter. Fam Corp., a retail outlet located outside of Abel’s previously assigned sales territory, had never dealt with Abel. However, Fam knew of Abel as a result of various business contacts. After his dismissal, Abel sold Fam goods, to be delivered by Baker, and received from Fam a cash deposit for 25% of the purchase price. It was not unusual for an agent in Abel’s previous position to receive cash deposits. In an action by Fam against Baker on the sales contract, Fam will
   a. Win, because a principal is an insurer of an agent’s acts.
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b. Win, because Baker’s notice was inadequate to terminate Abel’s apparent authority.
c. Lose, because Abel’s conduct constituted a fraud for which Baker is not liable.
d. Lose, because Abel lacked any express or implied authority to make the contract.

M85#5. Ritz hired West for six months as an assistant sales manager at $4,000 a month plus 3% of sales. Which of the following is correct?

a. The employment agreement must be in writing and signed by the party to be charged.
b. The agreement between Ritz and West formed an agency coupled with an interest.
c. West must disclose any interests he has which are adverse to Ritz in matters concerning Ritz’s business.
d. West can be dismissed by Ritz during the six months only for cause.

N84#14. Dent is an agent for Wein pursuant to a written agreement with a three-year term. After two years of the term, Wein decides that he would like to terminate the relationship with Dent. Wein may terminate the relationship

a. Without cause, but may be held liable for breach of contract.
b. Even if Dent is an agent coupled with an interest.
c. Without cause, but may be held liable for the intentional interference with an existing contract.
d. Only if Dent breaches the fiduciary duties owed to Wein.

N84#15. Sol, an agent for May, made a contract with Simon which exceeded Sol’s authority. If May wishes to hold Simon to the contract, May must prove that

a. Sol was May’s general agent even though Sol exceeded his authority.
b. Sol believed he was acting within the scope of his authority.
c. Sol was acting in the capacity of an agent for an undisclosed principal.
d. May ratified the contract before withdrawal from the contract by Simon.

M84#1. Dill is an agent for Mint, Inc. As such, Dill made a contract for and on behalf of Mint with Sky Co. which was not authorized and upon which Mint has disclaimed liability. Sky has sued Mint on the contract asserting that Dill had the apparent authority to make it. In considering the factors which will determine the scope of Dill’s apparent authority, which of the following would not be important?

a. The express limitations placed upon Dill’s authority which were not known by Sky.
b. The custom and usages of the business.
c. The status of Dill’s position in Mint.
d. Previous acquiescence by the principal in similar contracts made by Dill.

M84#2. Notice to third parties is not required to terminate a disclosed general agent’s apparent authority when the

a. Principal has died.
b. Principal revokes the agent’s authority.
c. Agent renounces the agency relationship.
d. Agency relationship terminates as a result of the fulfillment of its purpose.

M84#3. Harp entered into a contract with Rex on behalf of Gold. By doing so, Harp acted outside the scope of his authority as Gold’s agent. Gold may be held liable on the contract if

a. Gold retains the benefits of the contract.
b. Gold ratifies the entire contract after Rex withdraws from the contract.
c. Rex elects to hold Gold liable on the contract.
d. Rex was aware of the limitation on Harp’s authority.

M84#4. Jim, an undisclosed principal, authorized Rick to act as his agent in securing a contract for the purchase of some plain white paper. Rick, without informing Sam that he was acting on behalf of a principal, entered into a contract with Sam to purchase the paper. If Jim repudiates the contract with Sam, which of the following is correct?

a. Rick will be released from his contractual obligations to Sam if he discloses Jim’s identity.
b. Upon learning that Jim is the principal, Sam may elect to hold either Jim or Rick liable on the contract.
c. Rick may not enforce the contract against Sam.
d. Sam may obtain specific performance, compelling Jim to perform on the contract.

N83#12. Ivy Corp. engaged Jones as a sales representative and assigned him to a route in southern Florida. Jones worked out of Ivy’s main office and his duties, hours, and routes were carefully controlled. The employment contract contained a provision which stated: “I, Jones, do hereby promise to hold the corporation harmless from any and all tort liability to third parties which may arise in carrying out my duties as an employee.” On a sales call, Jones negligently dropped a case of hammers on the foot of Devlin, the owner of Devlin’s Hardware. Which of the following statements is correct?

a. Ivy has no liability to Devlin.
b. Although the exculpatory clause may be valid between Ivy and Jones, it does not affect Devlin’s rights.
c. Ivy is not liable to Devlin in any event, since Jones is an independent contractor.
d. The exculpatory clause is totally invalid since it is against public policy.
N83#13. Wall & Co. hired Carr to work as an agent in its collection department, reporting to the credit manager. Which of the following is correct?
   a. Carr does not owe a fiduciary duty to Wall since he does not compete with the company.
   b. Carr will be personally liable for any torts he commits even though they are committed in the course of his employment and pursuant to Wall’s directions.
   c. Carr has the implied authority to engage counsel and commence legal action against Wall’s debtors.
   d. Carr may commingle funds collected by him if this is convenient as long as he keeps proper records.

N83#14. Steel has been engaged by Lux to act as the agent for Lux, an undisclosed principal. As a result of this relationship
   a. Steel has the same implied powers as an agent engaged by a disclosed principal.
   b. Lux can not be held liable for any torts committed by Steel in the course of carrying out the engagement.
   c. Steel will be free from personal liability on authorized contracts for Lux when it is revealed that Steel was acting as an agent.
   d. Lux must file the appropriate form in the proper state office under the fictitious business name statute.

M83#2. Terrence has been Pauline’s agent in the liquor business for ten years and has made numerous contracts on Pauline’s behalf. Under which of the following situations could Terrence continue to have power to bind Pauline?
   a. The passage of a federal constitutional amendment making the sale or purchase of alcoholic beverages illegal.
   b. The death of Pauline without Terrence’s knowledge.
   c. The bankruptcy of Pauline with Terrence’s knowledge.
   d. The firing of Terrence by Pauline.

N82#5. The apparent authority of an agent would not be determined by reference to
   a. Prior dealings between the parties.
   b. The types of activity engaged in by the agent.
   c. An undisclosed limitation on the agent’s usual power.
   d. Industry custom.

M82#7. Mathews is an agent for Sears with the express authority to solicit orders from customers in a geographic area assigned by Sears. Mathews has no authority to grant discounts nor to collect payment on orders solicited. Mathews secured an order from Davidson for $1,000 less a 10% discount if Davidson makes immediate payment. Davidson had previously done business with Sears through Mathews but this was the first time that a discount-payment offer had been made. Davidson gave Mathews a check for $900 and thereafter Mathews turned in both the check and the order to Sears. The order clearly indicated that a 10% discount had been given by Mathews. Sears shipped the order and cashed the check. Later Sears attempted to collect $100 as the balance owed on the order from Davidson. Which of the following is correct?
   a. Sears can collect the $100 from Davidson because Mathews contracted outside the scope of his express or implied authority.
   b. Sears can not collect the $100 from Davidson because Mathews as an agent with express authority to solicit orders had implied authority to give discounts and collect.

b. Wallop is bound to this contract only if Davidson acts within the scope of his authority.
c. If Davidson acts within the scope of his authority, Wallop can not hold Davidson personally liable on the contract.
d. Should Davidson refuse to accept delivery of the coal, Wallop will become an agent of Myers by substitution.

N82#34. Downtown Disco, Inc., engaged Charleston as club manager in a written agreement providing for a $20,000 salary, plus 2% of gross revenues, and exclusive management authority including entertainment bookings. The agreement is irrevocable by Downtown for three years but terminable by Charleston upon one month’s written notice. The Downtown-Charleston arrangement is
   a. An agency coupled with an interest.
   b. A partnership between Downtown and Charleston.
   c. Terminable at any time by Downtown despite the three-year irrevocability clause.
   d. Enforceable by Charleston by an action for specific performance.

M82#5. The liability of a principal to a third party for the torts of his agent
   a. Can be effectively limited by agreement with the agent.
   b. Can not extend to the inclusion of a criminal act committed by the agent.
   c. Is less onerous if the agent is acting for an undisclosed principal.
   d. Is an example of the imposition of liability without fault upon the principal.
c. Sears cannot collect the $100 from Davidson as Sears has ratified the discount granted and payment made to Mathews.
d. Sears cannot collect the $100 from Davidson because although Mathews had no express or implied authority to grant a discount and collect, Mathews had apparent authority to do so.

N81#12. Which of the following is not an essential element of an agency relationship?
   a. It must be created by contract.
   b. The agent must be subject to the principal’s control.
   c. The agent is a fiduciary in respect to the principal.
   d. The agent acts on behalf of another and not himself.

N81#13. To successfully invoke the doctrine of ratification
   a. The agent must have had the legal capacity to have so acted.
   b. The agent must in fact be the agent of the principal although the action taken was totally without authority.
   c. The ratification must have been stated expressly.
   d. The ratification must be made with knowledge of the material facts of the transaction.

N81#14. Kent works as a welder for Mighty Manufacturing, Inc. He was specially trained by Mighty in the procedures and safety precautions applicable to installing replacement mufflers on automobiles. One rule of which he was aware involved a prohibition against installing a muffler on any auto which had heavily congealed oil or grease or which had any leaks. Kent disregarded this rule, and, as a result, a customer’s auto caught fire causing extensive property damage and injury to Kent. Which of the following is correct?
   a. Mighty is not liable to Kent under the worker’s compensation laws.
   b. Mighty is not liable to the customer because Mighty’s rule prohibited Kent from installing the muffler in question.
   c. Kent does not have any personal liability to the customer for the loss because Kent was acting for and on behalf of his employer.
   d. Mighty is liable to the customer irrespective of its efforts to prevent such an occurrence and the fact that it exercised reasonable care.

N81#15. The key characteristic of a servant is that
   a. His physical conduct is controlled or subject to the right of control by the employer.
   b. He is paid at an hourly rate as contrasted with the payment of a salary.
   c. He is precluded from making contracts for and on behalf of his employer.
   d. He lacks apparent authority to bind his employer.

N81#16. Brian purchased an automobile from Robinson Auto Sales under a written contract by which Robinson obtained a security interest to secure payment of the purchase price. Robinson reserved the right to repossess the automobile if Brian failed to make any of the required ten payments. Ambrose, an employee of Robinson, was instructed to repossess the automobile on the ground that Brian had defaulted in making the third payment. Ambrose took possession of the automobile and delivered it to Robinson. It was then discovered that Brian was not in default. Which of the following is incorrect?
   a. Brian has the right to regain possession of the automobile and to collect damages.
   b. Brian may sue and collect from either Robinson or Ambrose.
   c. If Ambrose must pay in damages, he will be entitled to indemnification from Robinson.
   d. Ambrose is not liable for the wrongful repossess of the automobile since he was obeying the direct order of Robinson.

N81#29. Barton, a wealthy art collector, orally engaged Deiter to obtain a rare and beautiful painting from Cumbers, a third party. Cumbers did not know that Barton had engaged Deiter to obtain the painting for Barton because, as Barton told Deiter, “that would cause the price to skyrocket.” Regarding the liability of the parties if a contract is made or purported to be made, which of the following is correct?
   a. Since the appointment of Deiter was oral, no agency exists, and any contract made by Deiter on Barton’s behalf is invalid.
   b. Because Barton specifically told Deiter not to reveal for whom he (Deiter) was buying the painting, Deiter cannot be personally liable on the contract made on Barton’s behalf.
   c. If Deiter makes a contract with Cumbers which Deiter breaches, Cumbers may, after learning of the agreement between Barton and Deiter, elect to recover from either Barton or Deiter.
   d. If Deiter makes a contract to purchase the painting, without revealing he is Barton’s agent, Cumbers has entered into a contract which is voidable at his election.

N81#30. Moderne Fabrics, Inc., hired Franklin as an assistant vice president of sales at $2,000 a month. The employment had no fixed duration. In light of their relationship to each other, which of the following is correct?
   a. Franklin has a legal duty to reveal any interest adverse to that of Moderne in matters concerning his employment.
b. If Franklin voluntarily terminates his employment with Moderne after working for it for several years, he can not work for a competitor for a reasonable period after termination.

c. Moderne can dismiss Franklin only for cause.

d. The employment contract between the parties must be in writing.

M81#31. Sly was a general agent of the Cute Cosmetics Company with authority to sell, make collections, and adjust disputes. Sly was caught padding his monthly expense account by substantial amounts and was dismissed. Cute hired another general agent, Ready, to replace Sly. Ready was slowly but steadily calling upon Sly's accounts to make sales and was informing them that Sly's services had been terminated. Cute also published a notice in the appropriate trade journals and the local newspaper announcing the replacement of Sly with Ready. Sly, after he was let go, called on all the customers who had outstanding accounts payable and quickly made whatever collections he could in cash and absconded. Which of the following statements is correct regarding Cute's legal right against the customers?

a. Cute can retain possession of the goods since title did not pass because Sly's actions constituted a fraud.

b. Cute can obtain payment from the customers despite Sly's wrongful acts since it had published a notice of Sly's dismissal.

c. Cute will have to absorb the loss since Sly had continuing implied authority to make collections.

d. Cute will have to absorb the loss unless Cute can prove the customers had actual notice of Sly's dismissal.

M81#33. Duval Manufacturing Industries, Inc., orally engaged Harris as one of its district sales managers for an 18-month period commencing April 1, 1980. Harris commenced work on that date and performed his duties in a highly competent manner for several months. On October 1, 1980, the company gave Harris a notice of termination as of November 1, 1980, citing a downturn in the market for its products. Harris sues seeking either specific performance or damages for breach of contract. Duval pleads the Statute of Frauds and/or a justified dismissal due to the economic situation. What is the probable outcome of the lawsuit?

a. Harris will prevail because he has partially performed under the terms of the contract.

b. Harris will lose because his termination was caused by economic factors beyond Duval's control.

c. Harris will lose because such a contract must be in writing and signed by a proper agent of Duval.

d. Harris will prevail because the Statute of Frauds does not apply to contracts such as his.

M81#34. Jason Manufacturing Company wished to acquire a site for a warehouse. Knowing that if it negotiated directly for the purchase of the property the price would be substantially increased, it employed Kent, an agent, to secure lots without disclosing that he was acting for Jason. Kent's authority was evidenced by a writing signed by the proper officers of Jason. Kent entered into a contract in his own name to purchase Peter's lot, giving Peter a negotiable note for $1,000 signed by Kent as first payment. Jason wrote Kent acknowledging the purchase. Jason also disclosed its identity as Kent's principal to Peter. In respect to the rights and liabilities of the parties, which of the following is a correct statement?

a. Peter is not bound on the contract since Kent's failure to disclose he was Jason's agent was fraudulent.

b. Jason, Kent and Peter are potentially liable on the contract.

c. Unless Peter formally ratifies the substitution of Jason for Kent, he is not liable.

d. Kent has no liability since he was acting for and on behalf of an existing principal.

B. Partnerships and Joint Ventures

M85#6. The apparent authority of a partner to bind the partnership in dealing with third parties

a. Must be derived from the express powers and purposes contained in the partnership agreement.

b. Would permit a partner to submit a claim against the partnership to arbitration.

c. Will be effectively limited by a formal resolution of the partners of which third parties are aware.

d. Will be effectively limited by a formal resolution of the partners of which third parties are unaware.

M85#7. Which of the following statements is correct regarding a limited partnership?

a. The general partner must make a capital contribution.

b. It can only be created pursuant to a statute providing for the formation of limited partnerships.

c. It can be created with limited liability for all partners.

d. At least one general partner must also be a limited partner.

M85#8. Jane White acquired Zelmo's partnership interest in ZBA Partnership. All partners agreed to admit White as a partner. Unless otherwise agreed, White's admission to the partnership will automatically

a. Release Zelmo from personal liability on partnership debts arising prior to the sale of his partnership interest.

b. Release Zelmo from any liability on partnership debts arising subsequent to the sale of his partnership interest.
c. Subject White to unlimited personal liability on partnership debts arising prior to her admission as a partner.
d. Limit White’s liability on partnership debts arising prior to her admission as a partner to her interest in partnership property.

M85#9. Unless otherwise provided for, the assignment of a partnership interest will result in the
a. Dissolution of the partnership.
b. Assignee obtaining the right to receive the share of the profits to which the assignor would have otherwise been entitled.
c. Assignee succeeding to the assignor’s rights to participate in the management of the partnership.
d. Vesting of the assignor’s right to inspect the partnership books in the assignee.

M85#10. Long, Pine, and Rice originally contributed $100,000, $60,000, and $20,000, respectively, to form the LPR Partnership. Profits and losses of LPR are to be distributed 1/2 to Long, 1/2 to Pine, and 1/6 to Rice. After operating for one year, LPR’s total assets on its books are $244,000, total liabilities to outside creditors are $160,000 and total capital is $84,000. The partners made no withdrawals. LPR has decided to liquidate. If all of the partners are solvent and the assets of LPR are sold for $172,000
a. Rice will personally have to contribute an additional $8,000.
b. Pine will personally have to contribute an additional $4,000.
c. Long, Pine, and Rice will receive $6,000, $4,000, and $2,000, respectively, as a return of capital.
d. Long and Pine will receive $28,000 and $4,000, respectively, and Rice will have to contribute an additional $20,000.

N84#11. Unless otherwise provided in the limited partnership agreement, which of the following statements is correct?
a. A general partner’s capital contribution may not consist of services rendered to the partnership.
b. Upon the death of a limited partner the partnership will be dissolved.
c. A person may own a limited partnership interest in the same partnership in which he is a general partner.
d. Upon the assignment of a limited partner’s interest, the assignee will become a substituted limited partner if the consent of two-thirds of all partners is obtained.

N84#12 and 13 are based on the following information:
Darla, Jack, and Sam have formed a partnership with each agreeing to contribute $100,000 cash. Jack and Sam each contributed $100,000 cash. Darla contributed $75,000 cash and agreed to pay an additional $25,000 two years later. After one year of operations the partnership is insolvent. The liabilities and fair market value of the assets of the partnership are as follows:

Assets
Cash $40,000
Trade accounts receivable 35,000
Receivable from Darla 25,000
Equipment 100,000

Liabilities
Trade accounts payable $410,000

Both Jack and Sam are personally insolvent. Darla has a net worth of $750,000.

12. If Darla is a general partner, what is her maximum potential liability?
   a. $95,000
   b. $185,000
   c. $210,000
   d. $235,000

13. If Darla is a limited partner, what is her maximum potential liability?
   a. $0
   b. $25,000
   c. $210,000
   d. $235,000

N83#15. Many states require partnerships to file the partnership name under laws which are generally known as fictitious name statutes. These statutes
a. Require a proper filing as a condition precedent to the valid creation of a partnership.
b. Are designed primarily to provide registration for tax purposes.
c. Are designed to clarify the rights and duties of the members of the partnership.
d. Have little effect on the creation or operation of a partnership other than the imposition of a fine for noncompliance.

N83#16. A general partner of a mercantile partnership
a. Can, by virtue of his acts, impose tort liability upon the other partners.
b. Has no implied authority if the partnership agreement is contained in a formal and detailed signed writing.
c. Can have his apparent authority effectively negated by express limitations in the partnership agreement.
d. Can not be sued individually for a tort he has committed in carrying on partnership business until the partnership has been sued and a judgment returned unsatisfied.
BUSINESS LAW

M83#17. Which of the following is a correct statement concerning a partner's power to bind the partnership?
   a. A partner has no authority to bind the partnership after dissolution.
   b. A partner can not bind the partnership based upon apparent authority when the other party to the contract knows that the partner lacks actual authority.
   c. A partner has no authority in carrying on the regular business of the partnership to convey real property held in the partnership name.
   d. A partner, acting outside the scope of the partner's apparent authority, but with express authority to act, can not bind the partnership unless the third party knows of the express authority.

M83#18. Vast Ventures is a limited partnership. The partnership agreement does not contain provisions dealing with the assignment of a partnership interest. The rights of the general and limited partners regarding the assignment of their partnership interests are
   a. Determined according to the common law of partnerships as articulated by the courts.
   b. Basically the same with respect to both types of partners.
   c. Basically the same with the exception that the limited partner must give ten days notice prior to the assignment.
   d. Different in that the assignee of the general partnership interest does not become a substituted partner, whereas the assignee of a limited partnership interest automatically becomes a substituted limited partner.

M83#21. Lamay Associates, a general partnership, and Delray Corporation are contemplating entering into a joint venture. Such a joint venture
   a. Will be treated as an association for federal income tax purposes and taxed at the prevailing corporate rates.
   b. Must incorporate in the state in which the joint venture has its principal place of business.
   c. Will be treated as a partnership in most important legal respects.
   d. Must be dissolved upon completion of a single undertaking.

M83#4. Donovan, a partner of Monroe, Lincoln, and Washington, is considering selling or pledging all or part of his interest in the partnership. The partnership agreement is silent on the matter. Donovan can
   a. Sell part but not all of his partnership interest.
   b. Sell or pledge his entire partnership interest without causing a dissolution.
   c. Pledge his partnership interest, but only with the consent of his fellow partners.
   d. Sell his entire partnership interest and confer partner status upon the purchaser.

M83#5. In determining the liability of a partnership for the acts of a partner purporting to act for the partnership without the authorization of fellow partners, which of the following actions will bind the partnership?
   a. The renewal of an existing supply contract which the other partners had decided to terminate and which they had specifically voted against.
   b. An assignment of the partnership assets in trust for the benefit of creditors.
   c. A written admission of liability in a lawsuit brought against the partnership.
   d. Signing the partnership name as a surety on a note for the purchase of that partner's summer home.

M82#2. A question has arisen in determining the partnership's liability for actions taken for and on behalf of a partnership, but which were in fact without express or implied authority. Which of the following actions taken by a general partner will bind the partnership?
   a. Renewing an existing supply contract which had previously been negotiated, but which the partners had specifically voted not to renew.
   b. Submitting a claim against the partnership to binding arbitration.
Selected Questions

c. Taking an action which was known by the party with whom he dealt to be in contravention of a restriction on his authority.
d. Signing the firm name as an accommodation co-maker on a promissory note not in furtherance of firm business.

M82#3. Stanley is a well-known retired movie personality who purchased a limited partnership interest in Terrific Movie Productions upon its initial syndication. Terrific has three general partners, who also purchased limited partnership interests, and 1,000 additional limited partners located throughout the United States. Which of the following is correct?
   a. If Stanley permits his name to be used in connection with the business and is held out as a participant in the management of the venture, he will be liable as a general partner.
   b. The sale of these limited partnership interests would be subject to SEC registration.
   c. This limited partnership may be created with the same informality as a general partnership.
   d. The general partners are prohibited from also owning limited partnership interests.

M82#4. Cavendish is a limited partner of Custer Venture Capital. He is extremely dissatisfied with the performance of the general partners in making investments and managing the portfolio. He is contemplating taking whatever legal action may be appropriate against the general partners. Which of the following rights would Cavendish not be entitled to assert as a limited partner?
   a. To have a formal accounting of partnership affairs whenever the circumstances render it just and reasonable.
   b. To have the same rights as a general partner to a dissolution and winding up of the partnership.
   c. To have reasonable access to the partnership books and to inspect and copy them.
   d. To have himself elected as a general partner by a majority vote of the limited partners in number and amount.

N81\#17. For which of the following does a partner have joint liability as contrasted with joint and several liability?
   a. The negligent injury of a third person by a partner while acting in the ordinary course of the firm's business.
   b. The misapplication of funds by a partner acting within the scope of his apparent authority.
   c. The intentional interference with an existing contractual relationship with the tacit approval of his fellow partners.
   d. The bond and mortgage on the partnership's office building.

N81\#18 and 19 are based on the following information:
   Daniels, Beal, and Wade agreed to form the DBW Partnership to engage in the import-export business. They had been lifelong friends and had engaged in numerous business dealings with each other. It was orally agreed that Daniels would contribute $20,000, Beal $15,000 and Wade $5,000. It was also orally agreed that in the event the venture proved to be a financial disaster all losses above the amounts of capital contributed would be assumed by Daniels and that he would hold his fellow partners harmless from any additional amounts lost. The partnership was consummated with a handshake and the contribution of the agreed-upon capital by the partners. There were no other express agreements.

18. Under these circumstances, which of the following is correct?
   a. Profits are to be divided in accordance with the relative capital contributions of each partner.
   b. Profits are to be divided equally.
   c. The partnership is a nullity because the agreement is not contained in a signed writing.
   d. Profits are to be shared in accordance with the relative time each devotes to partnership business during the year.

19. If the partnership becomes insolvent and the partnership debts exceed assets by $15,000, which of the following is correct insofar as the rights of partnership creditors are concerned?
   a. Daniels is a surety insofar as partnership debts in excess of $40,000 are concerned.
   b. Those creditors who were aware of the oral agreement among the partners regarding partnership liability are bound by it.
   c. Partnership creditors must first proceed against Daniels and have a judgment returned unsatisfied before proceeding against Beal or Wade.
   d. Each partner may be held jointly liable to firm creditors.

N81\#20. For which of the following is a partnership recognized as a separate legal entity?
   a. The liability for and payment of taxes on partnership gains from the sale of capital assets.
   b. In respect to contributions and advances made by partners to the partnership.
   c. The recognition of net operating losses.
   d. The status of the partnership as an employer for workers' compensation purposes.

N81\#21. Donaldson reached the mandatory retirement age as a partner of the Malcom and Black partnership. Edwards was chosen by the remaining partners to succeed Donaldson. The remaining partners agreed to assume all of Donaldson's partnership liability and
released Donaldson from such liability. Additionally, Edwards expressly assumed full liability for Donaldson's partnership liability incurred prior to retirement. Which of the following is correct?

- Edwards's assumption of Donaldson's liability was a matter of form since as an incoming partner he was liable as a matter of law.
- Firm creditors are not precluded from asserting rights against Donaldson for debts incurred while she was a partner, the agreements of Donaldson and the remaining partners notwithstanding.
- Donaldson has no continuing potential liability to firm creditors as a result of the agreements contained in the retirement plan.
- Since Donaldson obtained a release from firm debts she has no liability for debts incurred while she was a partner.

N81#22. Which of the following may a partner not do without the express unanimous assent of the remaining partners?

- Assign his entire partnership interest to an outsider.
- Dismiss the accounting firm engaged to audit the partnership's accounts.
- Submit a long-standing dispute regarding a partnership claim against a recalcitrant customer to arbitration.
- Obtain a short-term loan from the partnership's banker to increase the partnership's working capital.

N81#23. Wichita Properties is a limited partnership created in accordance with the provisions of the Uniform Limited Partnership Act. The partners have voted to dissolve and settle the partnership's accounts. Which of the following will be the last to be paid?

- General partners in respect to profits.
- Limited partners in respect to capital.
- Limited partners in respect to their share of the profits.
- General partners in respect to capital.

C. Corporations

M85#11. Which of the following is a correct statement concerning the similarities of a limited partnership and a corporation?

- Both are recognized for federal income tax purposes as taxable entities.
- Both can only be created pursuant to a statute and each must file a copy of its certificate with the proper state authorities.
- Both provide insulation from personal liability for all of the owners of the business.
- Shareholders and limited partners may both participate in the management of the business and retain limited liability.

M85#12. Which of the following statements is correct regarding the fiduciary duty?

- A director's fiduciary duty to the corporation may be discharged by merely disclosing his self-interest.
- A director owes a fiduciary duty to the shareholders but not to the corporation.
- A promoter of a corporation to be formed owes no fiduciary duty to anyone, unless the contract engaging the promoter so provides.
- A majority shareholder as such may owe a fiduciary duty to fellow shareholders.

M85#13. The corporate veil is most likely to be pierced and the shareholders held personally liable if

- The corporation has elected S corporation status under the Internal Revenue Code.
- A partnership incorporates its business solely to limit the liability of its partners.
- An ultra vires act has been committed.
- The shareholders have commingled their personal funds with those of the corporation.

M85#14. Generally, officers of a corporation

- Are elected by the shareholders.
- Are agents and fiduciaries of the corporation, having actual and apparent authority to manage the business.
- May be removed by the board of directors without cause only if the removal is approved by a majority vote of the shareholders.
- May declare dividends or other distributions to shareholders as they deem appropriate.

M85#15. The essential difference between a stock dividend and a stock split is that a

- Stock split will increase the amount of stockholders' equity.
- Stock split will increase a stockholder's percentage of ownership.
- Stock dividend must be paid in the same class of stock as held by the stockholder.
- Stock dividend of newly-issued shares will result in a decrease in retained earnings.

M84#5. Which of the following statements concerning cumulative preferred stock is correct?

- Upon the dissolution of a corporation the preferred shareholders have priority over unsecured judgment creditors.
- Preferred stock represents a type of debt security similar to corporate debentures.
- If dividends are not declared for any year, they become debts of the corporation for subsequent years.
- Upon the declaration of a cash dividend on the preferred stock, preferred shareholders become unsecured creditors of the corporation.
**Selected Questions**

**MB4#6.** Which of the following would be grounds for the judicial dissolution of a corporation on the petition of a shareholder?

a. Refusal of the board of directors to declare a dividend.
b. Waste of corporate assets by the board of directors.
c. Loss operations of the corporation for three years.
d. Failure by the corporation to file its federal income tax returns.

**MB4#7.** Able and Baker are two corporations, the shares of which are publicly traded. Baker plans to merge into Able. Which of the following is a requirement of the merger?

a. The IRS must approve the merger.
b. The common stockholders of Baker must receive common stock of Able.
c. The creditors of Baker must approve the merger.
d. The boards of directors of both Able and Baker must approve the merger.

**MB4#8.** For which of the following reasons would the corporate veil most likely be pierced and the shareholders held personally liable?

a. The corporation is a personal holding company.
b. The corporation was organized because the shareholders wanted to limit their personal liability.
c. The corporation and its shareholders do not maintain separate bank accounts and records.
d. The corporation's sole shareholder is another domestic corporation.

**MB4#9.** Which of the following statements concerning treasury stock is correct?

a. Cash dividends paid on treasury stock are transferred to stated capital.
b. A corporation may not purchase its own stock unless specifically authorized by its articles of incorporation.
c. A duly appointed trustee may vote treasury stock at a properly called shareholders' meeting.
d. Treasury stock may be resold at a price less than par value.

**MB4#10.** Generally, articles of incorporation must contain all of the following except the

a. Names of the incorporators.
b. Name of the corporation.
c. Number of shares authorized.
d. Names of initial officers and their terms of office.

**NB3#20.** King Corp. and Queen Corp. have decided to merge pursuant to the merger provisions of the Model Business Corporation Act, which is the law of their jurisdiction. The statutory merger

a. Is one type of tax-free reorganization recognized by the Internal Revenue Code.
b. Is subject to clearly defined rules regarding the percentage and types of securities which may be used to consummate the merger.
c. May cut off the rights of creditors of the merged corporation.
d. Requires the approval of the secretary of state or the attorney general at least 90 days prior to consummation of a merger or consolidation.

**NB3#24.** Ambrose purchased 400 shares of $100 par value original issue common stock from Minor Corporation for $25 a share. Ambrose subsequently sold 200 of the shares to Harris at $25 a share. Harris did not have knowledge or notice that Ambrose had not paid par. Ambrose also sold 100 shares of this stock to Gable for $25 a share. At the time of this sale, Gable knew that Ambrose had not paid par for the stock. Minor Corporation became insolvent and the creditors sought to hold all the above parties liable for the $75 unpaid on each of the 400 shares. Under these circumstances

a. The creditors can hold Ambrose liable for $30,000.
b. If $25 a share was a fair value for the stock at the time of issuance, Ambrose will have no liability to the creditors.
c. Since Harris acquired the shares by purchase, he is not liable to the creditors, and his lack of knowledge or notice that Ambrose paid less than par is immaterial.
d. Since Gable acquired the shares by purchase, he is not liable to the creditors, and the fact that he knew Ambrose paid less than par is immaterial.

**NB3#25.** Decanter Corporation declared a 10% stock dividend on its common stock. The dividend

a. Must be registered with the SEC pursuant to the Securities Act of 1933.
b. Requires a vote of the shareholders of Decanter.
c. Has no effect on the earnings and profits for federal income tax purposes.
d. Is includable in the gross income of the recipient taxpayers in the year of receipt.

M82#8. A court is most likely to disregard the corporate entity and hold shareholders personally liable when
   a. The owner-officers of the corporation do not treat it as a separate entity.
   b. A parent corporation creates a wholly owned subsidiary in order to isolate the high risk portion of its business in the subsidiary.
   c. A sole proprietor incorporates his business to limit his liability.
   d. The corporation has elected, under Subchapter S, not to pay any corporate tax on its income but, instead, to have the shareholders pay tax on it.

M82#9. Phillips was the principal promoter of the Waterloo Corporation, a corporation which was to have been incorporated not later than July 31, 1981. Among the many things to be accomplished prior to incorporation were the obtaining of capital, the hiring of key executives and the securing of adequate office space. In this connection, Phillips obtained written subscriptions for $1.4 million of common stock from individuals. He hired himself as the chief executive officer of Waterloo at $200,000 for five years and leased three floors of office space from Downtown Office Space, Inc. The contract with Downtown was made in the name of the corporation. Phillips had indicated orally that the corporation would be coming into existence shortly. The corporation did not come into existence through no fault of Phillips. Which of the following is correct?
   a. The subscribers have a recognized right to sue for and recover damages.
   b. Phillips is personally liable on the lease with Downtown.
   c. Phillips has the right to recover the fair value of his services rendered to the proposed corporation.
   d. The subscribers were not bound by their subscriptions until the corporation came into existence.

M82#10. Fairwell is executive vice president and treasurer of Wonder Corporation. He was named as a party in a shareholder derivative action in connection with certain activities he engaged in as a corporate officer. In the lawsuit, it was determined that he was liable for negligence in performance of his duties. Fairwell seeks indemnity from the corporation for his liability. The board would like to indemnify him. The articles of incorporation do not contain any provisions regarding indemnification of officers and directors. Indemnification

M81#21. Universal Joint Corporation has approached Minor Enterprises, Inc., about a tax-free statutory merger of Minor into Universal. The stock of both corporations is listed on the NYSE. Which of the following requirements or procedures need not be complied with in order to qualify as a statutory merger pursuant to state and federal laws?
   a. The boards of directors of both corporations must approve the plan of merger.
   b. Universal, the surviving corporation, must apply for and obtain a favorable revenue ruling from the Treasury Department.
   c. The boards of both corporations must submit the plan of merger to their respective shareholders for approval.
   d. The securities issued and exchanged by Universal for the shares of Minor must be registered since they are considered to be "offered" and "sold" for purposes of the Securities Act of 1933.

M81#22. The consideration for the issuance of shares by a corporation may not be paid in
   a. Tangible property.
   b. Intangible property.
   c. Services to be performed for the corporation.
   d. Services actually performed for the corporation.
Selected Questions

M81#23. Bixler obtained an option on a building he believed was suitable for use by a corporation he and two other men were organizing. After the corporation was successfully promoted, Bixler met with the Board of Directors who agreed to acquire the property for $200,000. Bixler deeded the building to the corporation and the corporation began business in it. Bixler's option contract called for the payment of only $155,000 for the building and he purchased it for that price. When the directors later learned that Bixler paid only $155,000, they demanded the return of Bixler's $45,000 profit. Bixler refused, claiming the building was worth far more than $200,000 both when he secured the option and when he deeded it to the corporation. Which of the following statements correctly applies to Bixler's conduct?

a. It was improper for Bixler to contract for the option without first having secured the assent of the Board of Directors.
b. If, as Bixler claimed, the building was fairly worth more than $200,000, Bixler is entitled to retain the entire price.
c. Even if, as Bixler claimed, the building was fairly worth more than $200,000, Bixler nevertheless must return the $45,000 to the corporation.
d. In order for Bixler to be obligated to return any amount to the corporation, the Board of Directors must establish that the building was worth less than $200,000.

M81#24. Delta Corporation has decided to purchase $2,000,000 of its own outstanding shares. In connection with this acquisition, which of the following is a correct statement?

a. The shares may not be acquired out of capital surplus.
b. The shares in question must be classified as treasury shares if not cancelled.
c. A subsequent offering of the acquired shares to the public in interstate commerce would be exempt from SEC registration.
d. If the shares are acquired at a price less than the original offering price, the corporation has realized a taxable capital gain.

M81#25. The stock of Crandall Corporation is regularly traded over the counter. However, 75% is owned by the founding family and a few of the key executive officers. It has had a cash dividend record of paying out annually less than 5% of its earnings and profits over the past 10 years. It has, however, declared a 10% stock dividend during each of these years. Its accumulated earnings and profits are beyond the reasonable current and anticipated needs of the business. Which of the following is correct?

a. The shareholders can compel the declaration of a dividend only if the directors' dividend policy is fraudulent.
b. The Internal Revenue Service can not attack the accumulation of earnings and profits since the Code exempts publicly held corporations from the accumulations provisions.
c. The fact that the corporation was paying a 10% stock dividend, apparently in lieu of a cash distribution, is irrelevant inasmuch as the ability of the Internal Revenue Service to successfully attack the accumulation.
d. Either the Internal Revenue Service or the shareholders could successfully obtain a court order to compel the distribution of earnings and profits unreasonably accumulated.

M81#26. Global Trucking Corporation has in its corporate treasury a substantial block of its own common stock, which it acquired several years previously. The stock had been publicly offered at $25 a share and had been reacquired at $15. The board is considering using it in the current year for various purposes. For which of the following purposes may it validly use the treasury stock?

a. To pay a stock dividend to its shareholders.
b. To sell it to the public without the necessity of a registration under the Securities Act of 1933, since it had been previously registered.
c. To vote it at the annual meeting of shareholders.
d. To acquire the shares of another publicly held company without the necessity of a registration under the Securities Act of 1933.

M81#27. The Larkin Corporation is contemplating a two-for-one stock split of its common stock. Its $4 par value common stock will be reduced to $2 after the split. It has 2 million shares issued and outstanding out of a total of 3 million authorized. In considering the legal or tax consequences of such action, which of the following is a correct statement?

a. The transaction will require both authorization by the Board of Directors and approval by the shareholders.
b. The distribution of the additional shares to the shareholders will be taxed as a dividend to the recipients.
c. Surplus equal to the par value of the existing number of shares issued and outstanding must be transferred to the stated capital account.
d. The trustees of trust recipients of the additional shares must allocate them ratably between income and corpus.

D. Estates and Trusts

M85#58. Fine wishes to establish an inter vivos trust for the benefit of his daughter Sally, naming Sally as the sole income beneficiary for 20 years and as the sole remainder beneficiary of the corpus. The intended trust will fail if the instrument creating the trust

a. Provides for the trustee to serve without compensation, bond or other security.
b. Is not supported by any consideration.
c. Fails to name a trustee.
d. Names Sally as the sole trustee.
M82#55. Assuming that a given trust indenture is silent on the point, the trustee has certain rights and duties as a matter of law. The trustee
   a. Has a fiduciary duty to the trust but not to the beneficiaries.
   b. Is not entitled to commissions unless so provided.
   c. Can elect to terminate the trust as long as the beneficiaries unanimously concur.
   d. Must act in a competent, nonnegligent manner, or he may face removal.

M82#56. Wayne & Company, CPAs, was engaged by Harding, the trustee of the Timmons Testamentary Trust. The will creating the Timmons Trust gave Harding wide discretion with respect to the investment of the trust principal but was silent on the question of the allocation of receipts and charges to principal or income. Among the assets invested in by Harding is a $500,000 annuity and a $50,000 limited partnership interest in an offshore investment limited partnership. The partnership has reported a $40,000 loss for the year. Regarding the trust in general and the limited partnership loss allocation in particular, which of the following is correct?
   a. It is against public policy to permit the investment by the trustee in the offshore investment limited partnership.
   b. Since the trust is silent on the allocation question, Harding has wide discretion in making allocations.
   c. The loss attributable to the offshore partnership is allocable equally to principal and income.
   d. The receipts from the $500,000 annuity must be apportioned between principal and income.

M82#57. Martins created an irrevocable fifteen-year trust for the benefit of his minor children. At the end of the fifteen years, the principal reverts to Martins. Martins named the Bloom Trust Company as trustee and provided that Bloom would serve without the necessity of posting a bond. In understanding the trust and rules applicable to it, which of the following is correct?
   a. If Martins dies ten years after creation of the trust, it is automatically revoked and the property is distributed to the beneficiaries of his trust upon their attaining age 21.
   b. Martins may revoke the trust after eleven years, since he created it, and the principal reverts to him at the expiration of the fifteen years.
   c. The facts indicate that the trust is a separate legal entity for both tax and non-tax purposes.
   d. The trust is not a separate legal entity for federal tax purposes.

M81#54. Harper died and his will was admitted to probate. It named his son Harris and his daughter Jean as co-executors. Under the terms of the will, he left 60% of his estate outright to his wife, Martha, after all expenses, taxes, and fees were paid. The balance was equally divided among his children, Harris, Jean, Tobey, and Lydia. The value of the gross estate is $400,000. Which of the following is correct?
   a. Martha would be better off electing to take under the interstate succession laws.
   b. The estate will be able to take a $250,000 statutory marital deduction.
   c. Tobey and Lydia are also entitled to qualify as executors since Harris and Jean are residuary takers as well as executors.
   d. All the property bequeathed to Martha will be deducted from Harper's estate for federal estate tax purposes.

M81#49. With respect to trusts, which of the following states an invalid legal conclusion?
   a. The trustee must obtain the consent of the majority of the beneficiaries if a major change in the investment portfolio of the trust is to be made.
   b. For federal income tax purposes, a trust is entitled to an exemption similar to that of an individual although not equal in amount.
   c. Both the life beneficiaries of a trust and the ultimate takers have rights against the trustee, and the trustee is accountable to them.
   d. A trust is a separate taxable entity for federal income tax purposes.

M81#51. Shepard created an inter vivos trust for the benefit of his children with the remainder to his grandchildren upon the death of his last surviving child. The trust consists of both real and personal property. One of the assets is an apartment building. In administering the trust and allocating the receipts and disbursements, which of the following would be improper?
   a. The allocation of forfeited rental security deposits to income.
   b. The allocation to principal of the annual service fee of the rental collection agency.
   c. The allocation to income of the interest on the mortgage on the apartment building.
   d. The allocation to income of the payment of the insurance premiums on the apartment building.

The Martin Trust consisted primarily of various income-producing real estate properties. During the year, the trustee incurred various charges. Among the charges were the following: depreciation, principal payments on various mortgages, and a street assessment. Which of the following would be a proper allocation of these items?
   a. All to income, except the street assessment.
   b. All are to be allocated equally between principal and income.
   c. All to principal.
   d. All to principal, except depreciation.
Selected Questions

III. Contracts

A. Offer and Acceptance

M85 Items 20 through 22 are based on the following information:

After substantial oral negotiations, Ida Frost wrote Jim Lane on May 1 offering to pay Lane $160,000 to build a warehouse. The writing contained the terms essential to form a binding contract. It also provided that the offer would remain open until June 1 and that acceptance must be received to be effective. On May 20, Lane mailed a signed acceptance. This was received by Frost on May 22. Lane completed the warehouse on July 15. On July 30, Lane assigned his right to receive payment to Reid Bank which did not notify Frost of the assignment. Two weeks later, Frost paid Lane $155,000 after deducting $5,000 in satisfaction of a dispute between them unrelated to the construction contract.

21. Frost’s offer
   a. Was accepted and a contract duly formed on May 20.
   b. Was irrevocable until June 1.
   c. Constituted a firm offer under the UCC despite the lack of consideration.
   d. Could have been revoked any time prior to the receipt of Lane’s acceptance on May 22.

N84#16. Fine Tuning, Inc., sent Watson a letter offering to sell Watson a custom-made automobile for $75,000. Watson immediately sent a telegram to Fine purporting to accept the offer. However, the telegraph company erroneously delivered the telegram to Pine Tuna, Inc. Three days later, Fine mailed a letter of revocation to Watson which was received by Watson. Fine refused to sell Watson the automobile. Watson sued Fine for breach of contract. Fine
   a. Will be liable for breach of contract.
   b. Will avoid liability due to the telegraph company’s error.
   c. Will avoid liability since it revoked its offer prior to receiving Watson’s acceptance.
   d. Would have been liable under the deposited acceptance rule only if Watson had accepted by mail.

N84#17. The president of Smith, Inc., wrote to Johnson offering to sell the Smith warehouse for $190,000. The offer was sent by Smith on May 1 and was received by Johnson on May 5. The offer stated that it would remain open until November 15. The offer
   a. Is a firm offer under the UCC since it is in writing.
   b. Is a firm offer under the UCC but will be irrevocable for only three months.
   c. May be revoked by Smith any time prior to Johnson’s acceptance.
   d. Constitutes an enforceable option.

N84#18. The following conversation took place between Mary and Ed. Mary: “Ed, if you wanted to sell your table, what would you ask for it?” Ed: “I suppose $400 would be a fair price.” Mary: “I’ll take it, if you will have it refinished.” Ed: “Sold.” Thus
   a. Ed’s statement: “I suppose $400 would be a fair price” constituted an offer.
   b. Mary’s reply: “I’ll take it, if you will have it refinished” was a conditional acceptance, terminating Ed’s offer.
   c. No contract resulted since Ed never stated he would actually sell the table for $400.
   d. A contract was formed when Ed said: “Sold.”

N84#19. On January 1, Lemon wrote Martin offering to sell Martin his ranch for $80,000 cash. Lemon’s letter indicated that the offer would remain open until February 15 if Martin mailed $100 by January 10. On January 5, Martin mailed $100 to Lemon. On January 30, Martin telephoned Lemon stating that he would be willing to pay $60,000 for the ranch. Lemon refused to sell at that price and immediately placed the ranch on the open market. On February 6, Martin mailed Lemon a letter accepting the original offer to buy the ranch at $80,000. The following day, Lemon received Martin’s acceptance. At that time the ranch was on the market for $100,000. Which of the following is correct?
   a. Martin’s mailing of $100 to Lemon on January 5 failed to create an option.
   b. Martin’s communication of January 30 automatically terminated Lemon’s offer of January 1.
   c. The placing of the ranch on the market by Lemon constituted an effective revocation of his offer of January 1.
   d. Martin’s letter of February 6 formed a binding contract based on the original terms of Lemon’s January 1 letter.

M84#15. Pine Co. published circulars containing price quotes and a description of products which it would like to sell. Bean, a prospective customer, demands the right to purchase one of the products at the quoted price. Which of the following statements is correct under general contract law?
   a. Pine has made an offer.
   b. Bean has made an offer.
   c. Pine must sell the product which Bean demands at the quoted price.
   d. Bean has accepted Pine’s firm offer to sell.

N83#27. Flaxx, a sales representative of Dome Home Sites, Inc., escorted Mr. and Mrs. Grand through several acres of Dome’s proposed subdivision and showed
the Grands various one-acre lots for sale at $27,000 each. Upon conclusion of the tour, the Grands expressed interest in purchasing a lot in the near future. Flaxx urged them to show their good faith and sign a letter of intent, which stated: "We, the undersigned, having decided to purchase a lot from Dome Home Sites in the future, deliver to the corporation's agent one hundred dollars ($100) earnest money." This was signed by the Grands at the bottom of the form and the $100 was delivered to Flaxx by the Grands. Under the circumstances
a. The Grands have made an offer to buy a lot from Dome.
b. If all the lots are sold by Dome, the Grands have a cause of action for breach of contract.
c. If no deal is ever consummated, the Grands have the right to the return of the $100.
d. The $100 constitutes liquidated damages and will be forfeited in the event the Grands do not purchase a lot.

N83#29. West sent a letter to Baker on October 18, 1983, offering to sell a tract of land for $70,000. The offer stated that it would expire on November 1, 1983. Baker sent a letter on October 25, indicating the price was too high and that he would be willing to pay $62,500. On the morning of October 26, upon learning that a comparable property had sold for $72,500, Baker telephoned West and made an unconditional acceptance of the offer at $70,000. West indicated that the price was now $73,000. Baker’s letter offering $62,500 arrived the afternoon of October 26. Under the circumstances
a. West’s letter was a firm offer as defined under the Uniform Commercial Code.
c. There is no contract since Baker’s acceptance was not in a signed writing.
d. The parol evidence rule will preclude Baker from contradicting his written statements with oral testimony contra to his letter of October 25.

M83#6. In determining whether a bilateral contract has been created, the courts look primarily at
a. The fairness to the parties.
b. The objective intent of the parties.
c. The subjective intent of the parties.
d. The subjective intent of the offeror.

M83#8. Justin made an offer to pay Benson $1,000 if Benson would perform a certain act. Acceptance of Justin’s offer occurs when Benson
a. Promises to complete the act.
b. Prepares to perform the act.
c. Promises to perform and begins preliminary performance.
d. Completes the act.

M83#9. Luxor wrote Harmon offering to sell Harmon Luxor’s real estate business for $200,000. Harmon sent a telegram accepting the offer at $190,000. Later, learning that several other parties were interested in purchasing the business, Harmon telephoned Luxor and made an unqualified acceptance on Luxor’s terms. The telegram arrived an hour after the phone call. Under the circumstances
a. Harmon’s telegram effectively terminated the offer.
b. Harmon’s oral acceptance is voidable, because real estate is involved.
c. The offer was revoked as a result of Harmon’s learning that others were interested in purchasing the business.
d. Harmon has made a valid contract at $200,000.

N82#1. On October 1, 1982, Arthur mailed to Madison an offer to sell a tract of land located in Summerville for $13,000. Acceptance was to be not later than October 10. Madison posted his acceptance on the 6th of October. The acceptance arrived on October 7th. On October 4th, Arthur sold the tract in question to Larson and mailed to Madison notice of the sale. That letter arrived on the 6th of October, but after Madison had dispatched his letter of acceptance. Which of the following is correct?
a. There was a valid acceptance of the Arthur offer on the day Madison posted his acceptance.
b. Arthur’s offer was effectively revoked by the sale of the tract of land to Larson on the 4th of October.
c. Arthur could not revoke the offer to sell the land until after October 10th.
d. Madison’s acceptance was not valid since he was deemed to have notice of revocation prior to the acceptance.

N82#3. Starbuck Corporation sent Crane Company an offer by a telegram to buy its patent on a calculator. The Starbuck telegram indicated that the offer would expire in ten days. The telegram was sent on February 1, 1982, and received on February 2, 1982, by Crane. On February 8, 1982, Starbuck telephoned Crane and indicated it was withdrawing the offer. Crane telegraphed an acceptance on the 11th of February. Which of the following is correct?
a. Starbuck’s withdrawal of the offer was ineffective because it was not in writing.
b. The offer was an irrevocable offer, but Crane’s acceptance was too late.
c. No contract arose since Starbuck effectively revoked the offer on February 8, 1982.
d. Since Crane used the same means of communication, acceptance was both timely and effective.

N82#44. Lee Motors sold an oral option to Hall, Inc., for $50. The option was to purchase any late model
used automobiles received by Lee as trade-ins on new
cars for the next 100 days. Hall paid the $50 and
promptly sent Lee a signed memorandum which cor-
rectly described the agreement and its terms. Lee did
not respond until after 30 days had elapsed and it had
discovered it had made a very bad bargain. Therefore,
it notified Hall that it would no longer perform under
the terms of the option, which it alleged was invalid,
and it enclosed a check for $50 to Hall’s order. Which
of the following is correct?
  a. The oral option is invalid for lack of consid-
eration.
  b. The Statute of Frauds can be validly asserted
     by Lee to avoid liability.
  c. Lee has entered into a valid contract with
     Hall.
  d. Options for a duration of more than three
     months are unenforceable.

M82#15. On May 1st, Perry Boat Sales sent a letter
to James offering to sell James a boat for $4,000. James
received the offer the morning of May 3rd. That after-
noon, James delivered an acceptance to the telegraph
office. Due to an error by the telegraph company, the
acceptance was never received by Perry. Which of the
following is correct?
  a. Perry is bound to a contract even though the
telegram of acceptance was never received.
  b. Perry is not bound to a contract because the
telegraph company’s error excused him of any
   responsibility.
  c. Perry would be bound to a contract only if
   James had sent his acceptance by mail.
  d. If Perry had sold the boat to Evans, without
   James’s knowledge, before James delivered
   his acceptance to the telegraph office, Perry
   would not be bound in contract to James.

N81#4. Which of the following offers for the sale of
the Lazy L Ranch is enforceable?
  a. Owner tells buyer she will sell the ranch for
     $35,000 and that the offer will be irrevocable
     for ten days.
  b. Owner writes buyer offering to sell the ranch
     for $35,000 and stating that the offer will re-
     main open for ten days.
  c. Owner telegraphs buyer offering to sell the
     ranch for $35,000 and promises to hold the
     offer open for ten days.
  d. Owner writes buyer offering to sell the ranch
     for $35,000 and stating that the offer will be
     irrevocable for ten days if buyer will pay
     $1.00. Buyer pays.

N81#7. Water Works had a long-standing policy
of offering employees $100 for suggestions actually used.
Due to inflation and a decline in the level and quality
of suggestions received, Water Works decided to in-
crease the award to $500. Several suggestions were un-
der consideration at that time. Two days prior to the
public announcement of the increase to $500, a sug-
gestion by Farber was accepted and put into use. Farber
is seeking to collect $500. Farber is entitled to
  a. $500 because Water Works had decided to
     pay that amount.
  b. $500 because the suggestion submitted will be
     used during the period that Water Works indi-
     cated it would pay $500.
  c. $100 in accordance with the original offer.
  d. Nothing if Water Works chooses not to pay
     since the offer was gratuitous.

N81#9. Nichols wrote Dilk and offered to sell Dilk a
building for $50,000. The offer stated it would expire
30 days from July 1, 1981. Nichols 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
of the following is correct?
  a. The offer will not expire prior to the 30 days
     even if Nichols sells the property to a third
     person and notifies Dilk.
  b. If Dilk categorically rejects the offer on July
     10th, Dilk can not validly accept within the
     remaining stated period of time.
  c. If Dilk phoned Nichols on August 1 and un-
     equivocally accepted the offer, it would create
     a contract, provided he had no notice of with-
     drawal of the offer.
  d. The offer can not be legally withdrawn for the
     stated period of time.

N81#11. Where a client accepts the services of an ac-
countant without an agreement concerning payment
there is
  a. An implied in fact contract.
  b. An implied in law contract.
  c. An express contract.
  d. No contract.

M81#8. Harper is opening a small retailing business
in Hometown, U.S.A. To announce her grand opening,
Harper places an advertisement in the newspaper quot-
ing sale prices on certain items in stock. Many local
residents come in and make purchases. Harper’s grand
opening is such a huge success that she is unable to
totally satisfy the demand of the customers. Which of
the following correctly applies to the situation?
  a. Harper has made an offer to the people read-
     ing the advertisement.
  b. Harper has made a contract with the people
     reading the advertisement.
  c. Harper has made an invitation seeking offers.
  d. Any customer who demands the goods ad-
     vertised and tenders the money is entitled to
     them.
M81#9. Martin sent Dobbs the following offer by mail:

I offer you 150 fantastic television sets, model J-1, at $65 per set, F.O.B. your truck at my warehouse, terms 2/10, net/30. I am closing out this model, hence the substantial discount. Accept all or none. (signed) Martin

Dobbs immediately wired back:

I accept your offer re the fantastic television sets, but will use Blue Express Company for the pickup, at my expense of course. In addition, if possible, could you have the shipment ready by Tuesday at 10:00 AM because of the holidays? (signed) Dobbs

Based on the above correspondence, what is the status of Dobbs' acceptance?

a. It is valid upon dispatch despite the fact it states both additional and different terms than those contained in the offer.
b. It is valid but will not be effective until received by Martin.
c. It represents a counteroffer which will become a valid acceptance if not negated by Martin within ten days.
d. It is not a valid acceptance because it states both additional and different terms than those contained in the offer.

M81#10. On March 1, Wilkins wrote Conner a letter and offered to sell him his factory for $150,000. The offer stated that the acceptance must be received by him by April 1. Under the circumstances, Wilkins's offer

a. Will be validly accepted if Conner posts an acceptance on April 1.
b. May be withdrawn at any time prior to acceptance.
c. May not be withdrawn prior to April 1.
d. Could not be validly accepted since Wilkins could assert the Statute of Frauds.

M81#11. Maurice sent Schmit Company a telegram offering to sell him a one-acre tract of commercial property located adjacent to Schmit's warehouse for $8,000. Maurice stated that Schmit had three days to consider the offer and in the meantime the offer would be irrevocable. The next day Maurice received a better offer from another party, and he telephoned Schmit informing him that he was revoking the offer. The offer was

a. Irrevocable for three days upon receipt by Schmit.
b. Effectively revoked by telephone.
c. Never valid, since the Statute of Frauds applies.
d. Not effectively revoked because Maurice did not use the same means of communication.

M81#13. Wilcox mailed Norriss an unsigned contract for the purchase of a tract of real property. The contract represented the oral understanding of the parties as to the purchase price, closing date, type of deed, and other details. It called for payment in full in cash or certified check at the closing. Norriss signed the contract, but added above his signature the following:

This contract is subject to my (Norriss) being able to obtain conventional mortgage financing of $100,000 at 13% or less interest for a period of not less than 25 years.

Which of the following is correct?

a. The parties had already made an en forceable contract prior to Wilcox's mailing of the formalized contract.
b. Norriss would not be liable on the contract under the circumstances even if he had not added the "conventional mortgage" language since Wilcox had not signed it.
c. By adding the "conventional mortgage" language above his signature, Norriss created a condition precedent to his contractual obligation and made a counteroffer.
d. The addition of the "conventional mortgage" language has no legal effect upon the contractual relationship of the parties since it was an implied condition in any event.

B. Consideration

M85#18. Fuller sent Blue a written offer to sell his tract of land located in Capetown for $75,000. The parties were engaged in a separate dispute. The offer stated that it would be irrevocable for 60 days if Blue would promise to refrain from suing Fuller during this time. Blue promptly delivered a promise not to sue during the term of the offer and to forego suit if she accepted the offer. Fuller subsequently decided that the possible suit by Blue was groundless and therefore phoned Blue and revoked the offer 15 days after making it. Blue mailed an acceptance on the 20th day. Fuller did not reply. Under the circumstances

a. Fuller's revocation, not being in writing, was invalid.
b. Fuller's offer was supported by consideration and was irrevocable when accepted.
c. Fuller's written offer would be irrevocable even without consideration.
d. Blue's promise was accepted by Fuller by his silence.

M84#14. Which of the following requires consideration in order to be binding on the parties?

a. Material modification of a sale of goods contract under the UCC.
b. Ratification of a contract by a person after reaching the age of majority.
c. Material modification of a contract involving the sale of real estate.
d. A written promise signed by a merchant to keep an offer to sell goods open for 10 days.
N83#26. In general, which of the following requirements must be satisfied in order to have a valid contract?

a. A writing.
b. Consideration.
c. Mutual promises.
d. Signatures of all parties.

N83#28. Love granted Nelson a written option to buy a tract of land in an industrial park. The option stated that it was irrevocable for 11 days and was given for $20 and other valuable consideration. The $20 was not paid and there was no other valuable consideration. Which of the following is a correct statement regarding the option in question?

a. Since real property is involved, Nelson's acceptance must be contained in a signed writing if Nelson is to enforce it against Love.
b. It is an option contract enforceable for the 11-day period.
c. Acceptance must be received at Love's place of business before expiration of the 11 days.
d. It is unenforceable because it lacks consideration.

M83#7. Dougal is seeking to avoid performing a promise to pay Clark $500. Dougal is relying upon lack of consideration on Clark's part sufficient to support his promise. Dougal will prevail if he can establish that

a. The contract is executory.
b. Clark's asserted consideration is worth only $100.
c. Prior to Dougal's promise, Clark had already performed the requested act.
d. Clark's only claim of consideration was the relinquishment of a legal right.

M82#12. Bunker's son, Michael, was seeking an account executive position with Harrison, Inc., the largest brokerage firm in the United States. Michael was very independent and wished no interference by his father. The firm, after several weeks deliberation, decided to hire Michael. They made him an offer on April 12, 1982, and Michael readily accepted. Bunker feared that his son would not be hired. Unaware of the fact that his son had been hired, Bunker mailed a letter to Harrison on April 13 in which he promised to give the brokerage firm $50,000 in commission business if the firm would hire his son. The letter was duly received by Harrison and they wished to enforce it against Bunker. Which of the following is correct?

a. Harrison will prevail since the promise is contained in a signed writing.
b. Past consideration is no consideration, hence there is no contract.
c. Harrison will prevail based upon promissory estoppel.
d. The preexisting legal rule applies and makes the promise unenforceable.

C. Capacity, Legality, and Public Policy

M85#16. Race entered into a written agreement to sell a parcel of land to Lark for $50,000. At the time the agreement was executed, Race had consumed a large amount of alcoholic beverages which significantly impaired Race's ability to understand the nature and terms of the contract. Lark knew Race was very intoxicated and that the land had been appraised at $95,000. Race wishes to avoid the contract. The contract is

a. Voidable at Race's option.
b. Voidable at Race's option only if the intoxication was involuntary.
c. Void.
d. Legally binding on both parties in the absence of fraud or undue influence.

N84#20. Aqua, Inc., a Florida corporation, entered into a contract for $30,000 with Sing, Inc., to perform plumbing services in a complex owned by Sing in Virginia. After the work was satisfactorily completed, Sing discovered that Aqua violated Virginia's licensing law by failing to obtain a plumbing license. Virginia's licensing statute was regulatory in nature, serving to protect the public against unskilled and dishonest plumbers. Upon Sing's request, independent appraisals of Aqua's work were performed, which indicated that the complex was benefited to the extent of $25,000. Sing refuses to pay Aqua. If Aqua brings suit it may recover

a. $30,000.
b. $25,000.
c. Nothing.
d. An amount sufficient to cover its out-of-pocket costs.

M84#11. Mix entered into a contract with Small which provided that Small would receive $10,000 if he stole trade secrets from Mix's competition. Small performed his part of the contract by delivering the trade secrets to Mix. Mix refuses to pay Small for his services. Under what theory may Small recover?

a. Quasi contract, in order to prevent the unjust enrichment of Mix.
b. Promissory estoppel, since Small has changed his position to his detriment.
c. None, due to the illegal nature of the contract.
d. Express contract, since both parties bargained for and exchanged promises in forming the contract.

M83#10. Fairbanks, an author, was approached by Nickle Corporation to ghostwrite the history of Nickle for $15,000. Larson, the president of Nickle, told Fairbanks the job was his if he would agree to cleverly defame its leading competitor, Mogul Corporation, using sly innuendo and clever distortion of the facts. Fairbanks wrote the history. It turned out that the Mogul passages were neither sly nor clever and Mogul obtained a judgment against Nickle. Fairbanks is seeking to collect the final $5,000 installment on the contract.
Nickle refuses to pay and seeks to recover the $10,000 it has already paid. In the event of a lawsuit
a. Fairbanks will recover $5,000.
b. The court will deny relief to either party.
c. Nickle will recover $10,000.
d. Fairbanks will recover in quantum meruit for the value of his services.

N82#8. Patton is a partner in an accounting firm. His partnership contract contains a clause which states that should Patton leave the firm, he agrees not to compete with the firm for one year, either as an individual or as a member of another accounting firm, anywhere within the city limits of New York City. The accounting firm does most of its business with clients in the states of New York, Pennsylvania and New Jersey. The clause would be held
a. Legally enforceable in most states.
b. An illegal restraint of trade under federal antitrust statutes.
c. Illegal, thereby invalidating the entire contract.
d. Unconscionable under the Uniform Commercial Code.

D. Statute of Frauds

N84#21. An oral contract to sell land will be enforceable if the
a. Contract is capable of full performance within one year.
b. Total sales price is less than $500.
c. Buyer has made a part payment.
d. Parties have fully performed the contract.

N84#22. Jim entered into an oral agency agreement with Sally whereby he authorized Sally to sell his interest in a parcel of real estate, Blueacre. Within seven days Sally sold Blueacre to Dan, signing the real estate contract on behalf of Jim. Dan failed to record the real estate contract within a reasonable time. Which of the following is correct?
a. Dan may enforce the real estate contract against Jim since it satisfied the Statute of Frauds.
b. Dan may enforce the real estate contract against Jim since Sally signed the contract as Jim's agent.
c. The real estate contract is unenforceable against Jim since Sally's authority to sell Blueacre was oral.
d. The real estate contract is unenforceable against Jim since Dan failed to record the contract within a reasonable time.

M83#12. The Statute of Frauds
a. Codified common law rules of fraud.
b. Requires that formal contracts be in writing and signed by the parties to the contract.
c. Does not apply if the parties waive its application in the contract.
d. Sometimes results in a contract being enforceable by only one party.

M83#13. Certain oral contracts fall outside the Statute of Frauds. An example would be a contract between
a. A creditor and a friend of the debtor, providing for the friend's guaranty of the debt in exchange for the creditor's binding extension of time for payment of the debt.
b. A landlord and a tenant for the lease of land for ten years.
c. A school board and a teacher entered into on January 1, for nine months of service to begin on September 1.
d. A retail seller of television sets and a buyer for the sale of a TV set for $399 C.O.D.

E. Statute of Limitations

M85#24. Diel entered into a written contract to sell a building to Stone. The contract was properly recorded. Stone breached the contract and Diel has brought an action for breach of contract. Stone pleads the statute of limitations as a defense. The
a. Time period fixed by the statute of limitations is uniform throughout the states.
b. Recording of the contract stops the running of the statute of limitations.
c. Time period fixed by the statute of limitations begins when the contract is recorded.
d. Remedy sought by Diel will be barred when the period of time provided by the statute of limitations has expired.

N81#2. When a lengthy delay has occurred between the breach of a contract and the commencement of the lawsuit, the statute of limitations defense may be raised. The statute
a. Is three years irrespective of the type of legal action the plaintiff is bringing.
b. Does not apply to an action brought in a court of equity.
c. Is a defense to recovery if the requisite period of time has elapsed.
d. Fixes a period of time in which the plaintiff must commence the action or be barred from recovery, regardless of the defendant's conduct during the period.

F. Fraud, Duress, and Undue Influence

M85#23. John Dash, an accountant, entered into a written contract with Kay Reese to perform certain tax services for Reese. Shortly thereafter, Reese was assessed additional taxes and she wanted to appeal the assessment. Reese was required to appeal immediately and the workpapers held by Dash were necessary to appeal. Dash refused to furnish Reese with the workpapers unless he was paid a substantially higher fee
than was set forth in the contract. Reese reluctantly agreed in order to meet the filing deadline. The contract as revised is

a. Voidable at Reese’s option based on undue influence.

b. Voidable at Reese’s option based on duress.

c. Void on the ground of undue influence.

d. Void on the ground of duress.

M83#15. Smith, an executive of Apex Corporation, became emotionally involved with Jones. At the urging of Jones, and fearing that Jones would sever their relationship, Smith reluctantly signed a contract which was grossly unfair to Apex. Apex’s best basis to rescind the contract would be

a. Lack of express authority.

b. Duress.

c. Undue influence.

d. Lack of consideration.

N82#9. In order to establish a common law action for fraud, the aggrieved party must establish that

a. Although the defendant did not in fact know that his statements were false, he made the false statements with a reckless disregard for the truth.

b. The contract entered into is within the Statute of Frauds.

c. There was a written misrepresentation of fact by the defendant.

d. The plaintiff acted as a reasonably prudent businessman in relying upon the misrepresentation.

M82#14. Paul filed a $20,000 fire loss claim with the Williams Fire Insurance Company. Dickerson, Williams’s adjuster, called Paul on the phone and invited him to come to his hotel room to settle the claim. Upon Paul’s entry to the room, Dickerson locked the door and placed the key in his pocket. He then accused Paul of having set the building on fire and of having been involved in several previous suspicious fire claims. Dickerson concluded by telling Paul that unless he signed a release in exchange for $500, he would personally see to it that Paul was prosecuted by the company for arson. Visibly shaken by all this, Paul signed the release. Paul has subsequently repudiated the release. The release is not binding because of

a. Fraud.

b. Lack of consideration.

c. Undue influence.

d. Duress.

N81#9. The element which makes fraud or deceit an intentional tort is

a. The materiality of the misrepresentation.

b. Detrimental reliance.

c. Actual reliance by the aggrieved party upon the misrepresentation.

d. Scienter or knowledge of falsity.

G. Mistake and Misrepresentation

M85#19. The primary distinction between an action based on innocent misrepresentation and an action based on common law fraud is that, in the former, a party need not allege and prove

a. That there has been a false representation.

b. The materiality of the misrepresentation.

c. Reasonable reliance on the misrepresentation.

d. That the party making the misrepresentation had actual or constructive knowledge that it was false.

M84#12. Pam orally agreed to sell Jack her used car for $400. At the time the contract was entered into, the car had been stolen and its whereabouts were unknown. Neither party was aware of these facts at the time the contract was formed. Jack sues Pam for her failure to deliver the car in accordance with their agreement. Pam’s best defense would be that the

a. Agreement was unenforceable because it was not evidenced by a writing.

b. Risk of loss for the car was on Jack.

c. Agreement is unconscionable.

d. Parties were under a mutual mistake of a material fact at the time the contract was entered into.

M83#14. Silvers entered into a contract which contains a substantial arithmetical error. Silvers asserts mistake as a defense to his performance. Silvers will prevail

a. Only if the mistake was a mutual mistake.

b. Only if the error was not due to his negligence.

c. If the error was unilateral and the other party knew of it.

d. If the contract was written by the other party.

N82#10. Which of the following is not required in order for the plaintiff to prevail in an action for innocent misrepresentation?

a. That the misrepresentation was intended to induce reliance.

b. That the misrepresentation amounted to gross negligence.

c. That the plaintiff acted promptly and offered to restore what was received.

d. That the plaintiff relied upon the misrepresentation.

N81#3. Madison advertised for the submission of bids on the construction of a parking lot. Kilroy submitted a bid of $112,000. There were nine other bids. Kilroy’s bid was $45,000 less than the next lowest bid. The discrepancy was due to the omission of a $46,000 item on the part of Kilroy’s staff. Madison accepted the bid and
demands either performance or damages from Kilroy. Kilroy is

a. Bound by the acceptance at $112,000.
b. Not bound by the acceptance but only if Madison knew of the mistake.
c. Not bound by the acceptance if the mistake should have been known by Madison.
d. Not bound by the bid submitted because there was no subjective meeting of the minds.

H. Parol Evidence Rule

M85#25. Where the parties have entered into a written contract intended as the final expression of their agreement, the parol evidence rule generally prevents the admission into evidence of any

a. Other written agreement which is referred to in the contract.
b. Contemporaneous oral agreement which explains an ambiguity in the written contract.
c. Prior oral or written agreement and any contemporaneous oral agreement which contradict the terms of the written contract.
d. Subsequent oral modification of the contract.

N84#23. Fred entered into a written contract with Joe to purchase a car. The written contract was intended to be the final and complete agreement of the parties. Fred is unhappy with the performance of the car and has commenced an action for breach of contract based on an oral representation made at the time the written contract was executed. Fred may introduce evidence of the representation if it

a. Completely modifies the written contract.
b. Contradicts the written agreement.
c. Serves to clarify an ambiguous term in the written contract.
d. Falls within the provisions of the Statute of Frauds.

M83#16. Elrod is attempting to introduce oral evidence in court to explain or modify a written contract he made with Weaver. Weaver has pleaded the parol evidence rule. In which of the following circumstances will Elrod not be able to introduce the oral evidence?

a. The modification asserted was made several days after the written contract had been executed.
b. The contract indicates that it was intended as the "entire contract" between the parties, and the point is covered in detail.
c. There was a mutual mistake of fact by the parties regarding the subject matter of the contract.
d. The contract contains an obvious ambiguity on the point at issue.

M83#41. With respect to written contracts, the parol evidence rule applies

a. Exclusively to the purchase or sale of goods.
b. To subsequent oral modifications.
c. Only to prior or contemporaneous oral modifications.
d. To modifications by prior written or oral agreements.

M81#12. Martin agreed to purchase a two-acre home site from Foxworth. The contract was drafted with great care and meticulously set forth the alleged agreement between the parties. It was signed by both parties. Subsequently, Martin claimed that the contract did not embody all of the agreements that the parties had reached in the course of their negotiations. Foxworth had asserted that the parol evidence rule applies. As such, the rule

a. Applies to both written and oral agreements relating to the contract made prior to the signing of the contract.
b. Does not apply to oral agreements made at the time of the signing of the contract.
c. Applies exclusively to written contracts signed by both parties.
d. Is not applicable if the Statute of Frauds applies.

I. Third Party Rights

M85#26. Fink is the owner of a parcel of land which is encumbered by a mortgage securing Fink's note to State Bank. Fink sold the land to Bloom who assumed the mortgage note. State Bank

a. Is a donee beneficiary.
b. Is an incidental beneficiary.
c. Is a creditor beneficiary.
d. Can not collect from Fink if Bloom defaults.

N84#25. Red purchased a life insurance policy from Ace Insurance Co. naming his wife Bertha as the sole beneficiary. In order for Bertha to qualify as a donee beneficiary she must

a. Have had knowledge of the insurance contract at the time the contract was entered into.
b. Be in privity of contract with Ace.
c. Have provided consideration.
d. Have been the person intended to be benefited from the life insurance contract.

M83#17. Nancy is asserting rights as a third party donee beneficiary on a contract made by Johnson and Harding. In order to prevail, Nancy must prove that

a. The contract specifically named her as the beneficiary.
b. She gave consideration for the donative promise.
c. She is related by blood or marriage to the promisee.
d. The terms of the contract and surrounding circumstances manifest a clear intent to benefit her.
Selected Questions

N82#11. A common law duty is delegable even though the
a. Contract provides that the duty is nondelegable.
b. Duty delegated is the payment of money and
the delegatee is not of as equal credit-worthiness as the delegator.
c. Delegation will result in a material variance in performance by the delegatee.
d. Duty to be performed involves personal services.

N82#12. Wilson sold his factory to Glenn. As part of
the contract, Glenn assumed the existing mortgage on
the property which was held by Security Bank. Regarding the rights and duties of the parties, which of
the following is correct?
a. The promise by Glenn need not be in writing
to be enforceable by Security.
b. Security is a creditor beneficiary of Glenn’s
promise and can recover against him personally in the event of default.
c. Security is a mere incidental beneficiary since
it was not a party to the assignment.
d. Wilson has no further liability to Security.

J. Assignments

M85

Items 20 through 22 are based on the following information:

After substantial oral negotiations, Ida Frost wrote
Jim Lane on May 1 offering to pay Lane $160,000
to build a warehouse. The writing contained the terms
essential to form a binding contract. It also provided
that the offer would remain open until June 1 and that
acceptance must be received to be effective. On May
20, Lane mailed a signed acceptance. This was received
by Frost on May 22. Lane completed the warehouse on
July 15. On July 30, Lane assigned his right to receive
payment to Reid Bank which did not notify Frost of
the assignment. Two weeks later, Frost paid Lane
$155,000 after deducting $5,000 in satisfaction of a dispute
between them unrelated to the construction contract.

22. If Reid sues Frost on the contract, Reid will be
entitled to recover
a. The full $160,000.
b. $160,000, less the $5,000 setoff.
c. Nothing, because notice of the assignment
was not given to Frost.
d. Nothing, because it was not the primary beneficiary of the construction contract.

M83#18. The assignment of a contract right
a. Will not be enforceable if it materially varies
the obligor’s promise.
b. Is invalid unless supported by consideration.
c. Gives the assignee better rights against the
obligor than the assignor had.
d. Does not create any rights in the assignee
against the assignor until notice is given to the
obligor.

N82#13. Walton owed $10,000 to Grant. Grant assigned
his claim against Walton to the Line Finance
Company for value on October 15, 1982. On October
25, 1982, Hayes assigned his matured claim for $2,000
against Grant to Walton for value. On October 30,
1982, Line notified Walton of the assignment to them
of the $10,000 debt owed by Walton to Grant. Line has
demanded payment in full. Insofar as the rights of the
various parties are concerned
a. Walton has the right of a $2,000 set-off against
the debt which he owed Grant.
b. Walton must pay Line in full, but has the right
to obtain a $2,000 reimbursement from Grant.
c. Line is a creditor beneficiary of the debt owed
by Walton.
d. The claimed set-off of the Hayes claim for
$2,000 is invalid since it is for an amount
which is less than the principal debt.

N81#5. Fennell and McLeod entered into a binding
contract whereby McLeod was to perform routine con-
struction services according to Fennell’s blueprints.
McLeod assigned the contract to Conerly. After the
assignment
a. Fennell can bring suit under the doctrine of
anticipatory breach.
b. McLeod extinguishes all his rights and duties
under the contract.
c. McLeod extinguishes all his rights but is not
relieved of his duties under the contract.
d. McLeod still has all his rights but is relieved
of his duties under the contract.

N81#10. Marglow Supplies Inc., mailed a letter to
Wilson Distributors on September 15, 1981, offering a
tree-year franchise dealership. The offer stated the
terms in detail and at the bottom stated that the offer
would not be withdrawn prior to October 1, 1981.
Which of the following is correct?
a. The Statute of Frauds would not apply to the
proposed contract.
b. The offer is an irrevocable option which can
not be withdrawn prior to October 1, 1981.
c. The offer can not be assigned to another party
by Wilson if Wilson chooses not to accept.
d. A letter of acceptance from Wilson to Mar-
glow sent on October 1, 1981, but not received
until October 2, 1981, would not create a valid
contract.

K. Discharge, Breach, and Remedies

M85#27. Bing engaged Dill to perform personal ser-
vice for $2,200 a month for a period of four months.
The contract was entered into orally on July 1, 1984, and performance was to commence September 1, 1984. On August 10, Dill anticipatorily repudiated the contract. As a result, Bing can
a. Not assign his rights to damages under the contract to a third party.
b. Obtain specific performance.
c. Not enforce the contract against Dill since the contract is oral.
d. Immediately sue for breach of contract.

N84#24. Ketchum Builders, Inc., contracted with Samson to construct a high-rise office building for $800,000. Ketchum inadvertently used materials which were not in accordance with the contract specifications. Although the breach resulted in minor damages, Samson has refused to pay Ketchum the $100,000 balance due on the contract. Ketchum
a. Will be denied recovery since any variation of the contract terms constitutes a breach of the entire contract.
b. Will be denied recovery based on the equitable doctrine of clean hands.
c. Is entitled to the entire $100,000 since it has substantially performed the contract.
d. Is entitled to the $100,000 less damages.

M84#13. Mary is seeking to avoid liability on a contract with Jeff. Mary can avoid liability on the contract if
a. The entire contract has been assigned.
b. There has been a subsequent unexecuted accord between Jeff and herself.
c. She has been discharged by a novation.
d. A third party has agreed to perform her duty and has for a valuable consideration promised to hold Mary harmless on the obligation to Jeff.

N83#22. Smith, CPA, contracted to perform certain services for Jones for $500. Jones claimed that the services were not fully performed and therefore disputed the amount of his obligation. As a result, Jones sent Smith a check for only $425 and marked clearly on the check it was "payment in full." Smith crossed out the words "payment in full" and cashed the check. The majority of courts would hold that the debt is
a. Liquidated and Smith can collect the remaining $75.
b. Liquidated, but Jones by adding the words "payment in full" cancelled the balance of the debt owed.
c. Unliquidated and the cashing of the check by Smith completely discharged the debt.
d. Unliquidated, but the crossing out of the words "payment in full" by Smith revives the balance of $75 owed.

M83#20. Myers entered into a contract to purchase a valuable rare coin from Eisen. Myers tendered payment which was refused by Eisen. Upon Eisen’s breach, Myers brought suit to obtain the coin. The court will grant Myers
a. Compensatory damages.
b. Specific performance.
c. Reformation.
d. Restitution.

N82#21. On August 1, 1982, Fields & Boss, CPAs, made a contract with Gil Manufacturing to audit Gil’s financial statements for calendar year 1982 and to render an opinion thereon. Gil agreed to an estimated fee of $7,500 for the services. Gil changed its mind and on September 2, 1982, before any services had been performed, notified Fields & Boss that it was repudiating the contract. Which of the following is correct?
   a. The CPA firm may sue for breach of contract immediately and need not wait until after performance is due and refused.
   b. The CPA firm is no longer bound on the contract but can sue until after January 1, 1983.
   c. The CPA firm remains bound by the contract until January 1, 1983.
   d. There has been a present breach of the contract.

M82#13. Foster offered to sell Lebow his garage for $27,000. The offer was in writing and signed by Foster. Foster gave Lebow five days to decide. On the fourth day Foster accepted a better offer from Dilby, who was unaware of the offer to Lebow. Foster subsequently conveyed the property to Dilby. Unaware of the sale to Dilby, Lebow telephoned Foster on the fifth day and unconditionally accepted the offer. Under the circumstances, Lebow
a. Is entitled to specific performance by Foster.
b. Has no rights against Foster.
c. Is entitled to damages.
d. Can obtain specific performance by Dilby upon depositing in court the $27,000 he agreed to pay.

N81#6. Monroe purchased a ten-acre land site from Acme Land Developers, Inc. He paid 10% at the closing and gave his note for the balance secured by a 20-year mortgage. Three years later, Monroe found it increasingly difficult to make payments on the note and finally defaulted. Acme Land threatened to accelerate the loan and foreclose if he continued in default. It told him either to get the money or obtain an acceptable third party to assume the obligation. Monroe offered the land to Thompson for $1,000 less than the equity he had in the property. This was acceptable to Acme and at the closing Thompson paid the arrearage, executed a new mortgage and note, and had title transferred to his name. Acme surrendered Monroe’s note and mortgage to him. The transaction in question is a
a. Assignment and delegation.
b. Third party beneficiary contract.
c. Novation.
d. Purchase of land subject to a mortgage.
IV. Debtor-Creditor Relationships

A. Suretyship

**M84#21.** Watt contacted Lenders Bank for a business loan. Lenders refused to make the loan unless adequate security or an acceptable surety could be provided. Watt asked Regis, one of his trade customers, to act as surety on the loan. In order to induce Regis to sign, Watt made certain fraudulent representations and submitted a materially false financial statement. He also promised Regis favorable treatment if Regis would agree to act as surety for him. Watt is now insolvent and Lenders seeks to hold Regis liable. Regis may avoid liability

a. Because Lenders had a duty to warn Regis about Watt’s financial condition and did not do so.
b. Because the law of suretyship favors the surety where neither the surety nor the creditor is at fault.
c. Based upon fraud if Regis can show Lenders was aware of the fraud.
d. Since the surety undertaking was void at the inception.

**M84**

**Items 22 and 23** are based on the following information:

Jane wishes to obtain a loan of $90,000 from Silver Corp. At the request of Silver, Jane has entered into an agreement with Bing, Piper, and Long to act as cosureties on the loan. The agreement between Jane and the cosureties stated that the maximum liability of each cosurety is: Bing $60,000, Piper $30,000, and Long $90,000. Based upon the surety relationship, Silver agreed to make the loan. After paying three installments totalling $30,000, Jane defaulted.

22. Prior to making payment, the cosureties may seek the remedy of

a. Contribution.
b. Indemnification.
c. Subrogation.
d. Exoneration.

23. If Long properly paid the entire debt outstanding of $60,000, what amount may Long recover from the cosureties?

a. $30,000 from Bing and $30,000 from Piper.
b. $20,000 from Bing and $20,000 from Piper.
c. $20,000 from Bing and $10,000 from Piper.
d. $15,000 from Bing and $15,000 from Piper.

**M84#24.** Which of the following defenses will release a surety from liability?

a. Insanity of the principal debtor at the time the contract was entered into.

b. Failure by the creditor to promptly notify the surety of the principal debtor’s default.
c. Refusal by the creditor, with knowledge of the surety relationship, to accept the principal debtor’s unconditional tender of payment in full.
d. Release by the creditor of the principal debtor’s obligation without the surety’s consent but with the creditor’s reservation of his rights against the surety.

**M83#25.** A distinction between a surety and a cosurety is that only one is entitled to

a. Compensation.
b. Subrogation.
c. Contribution.
d. Notice upon default.

**M83#26.** A release of a cosurety by the creditor

a. Will have no effect on the obligation of the other cosurety.
b. Will release the other cosurety entirely.
c. Will release the other cosurety to the extent that his right to contribution has been adversely affected.
d. Need not be a binding release in order to affect the rights of the parties.

**M83#27.** The right of subrogation

a. May permit the surety to assert rights he otherwise could not assert.
b. Is denied in bankruptcy.
c. Arises only to the extent that it is provided in the surety agreement.
d. Can not be asserted by a cosurety unless he includes all other cosureties.

**N82#20.** Gray and Far are cosureties on a loan of $100,000 made by the Durham Bank to Wilson Fabric, Inc. Gray guaranteed the loan in full and Far guaranteed $50,000 of the loan. Each was aware of the cosurety relationship. Gray received $50,000 of collateral from Wilson as a condition precedent to his serving as cosurety. Wilson has defaulted on the loan. With respect to their ultimate liabilities

a. Gray is liable for $50,000 but has the exclusive benefit of resort to the collateral to repay his loss.
b. Gray and Far will each be liable for $50,000.
c. Since Gray received collateral and Far did not, the relationship is actually one of sub-suretyship with Gray being liable for the entire amount.
d. In the final settlement between the sureties, Far will be liable for a net amount of $16,667.
Business Law

N82#22. Which of the following transactions does not establish Samp as a surety?
   a. Samp says: “Ship goods to my son and I will pay for them.”
   b. Samp signs commercial paper as an accommodation indorser for one of his suppliers.
   c. Samp guarantees a debt of a corporation he controls.
   d. Samp sells an office building to Park, and, as a part of the consideration, Park assumes Samp’s mortgage on the property.

N82#24. Knott obtained a loan of $10,000 from Charles on January 1, 1982, payable on April 15, 1982. At the time of the loan, Beck became a noncompensated surety thereon by written agreement. On April 15, 1982, Knott was unable to pay and wrote to Charles requesting an extension of time. Charles made no reply, but did not take any immediate action to recover. On May 30, 1982, Charles demanded payment from Knott and, failing to collect from him, proceeded against Beck. Based upon the facts stated
   a. Charles was obligated to obtain a judgment against Knott returned unsatisfied before he could collect from Beck.
   b. Beck is released from his surety obligation because Charles granted Knott an extension of time.
   c. Charles may recover against Beck despite the fact Beck was a noncompensated surety.
   d. Beck is released because Charles delayed in proceeding against Knott.

N82#25. Which of the following will release a surety from liability?
   a. Release of the principal debtor from liability with the consent of the surety.
   b. Delegation of the debtor’s obligation to another party with the acquiescence of the creditor.
   c. Lack of capacity because the debtor is a minor.
   d. Discharge of the debtor in bankruptcy.

N82#23. Which of the following defenses by a surety will be effective to avoid liability?
   a. Lack of consideration to support the surety undertaking.
   b. Insolvency in the bankruptcy sense by the debtor.
   c. Incompetency of the debtor to make the contract in question.
   d. Fraudulent statements by the principal-debtor which induced the surety to assume the obligation and which were unknown to the creditor.

N82#24. Dinsmore & Company was a compensated surety on the construction contract between Victor (the owner) and Gilmore Construction. Gilmore has defaulted and Victor has released Dinsmore for a partial payment and other consideration. The legal effect of the release of Dinsmore is
   a. To release Gilmore as well.
   b. Contingent on recovery from Gilmore.
   c. Binding upon Victor.
   d. To partially release Gilmore to the extent that Dinsmore’s right of subrogation has been diminished.

M82#25. In relation to the principal debtor, the creditor and a fellow surety, the surety is not entitled to
   a. Exoneration against the debtor under any circumstances.
   b. A pro rata contribution by his fellow surety or sureties if he pays the full amount.
   c. Be subrogated to the rights of the creditor upon satisfaction of the debt.
   d. Avoid performance because his surety refuses to perform.

N81#24. Dustin is a very cautious lender. When approached by Lanier regarding a $2,000 loan, he not only demanded an acceptable surety but also collateral equal to 50% of the loan. Lanier obtained King Surety Company as his surety and pledged rare coins worth $1,000 with Dustin. Dustin was assured by Lanier one week before the due date of the loan that he would have no difficulty in making payment. He persuaded Dustin to return the coins since they had increased in value and he had a prospective buyer. What is the legal effect of the release of the collateral upon King Surety?
   a. It totally releases King Surety.
   b. It does not release King Surety if the collateral was obtained after its promise.
   c. It releases King Surety to the extent of the value of the security.
   d. It does not release King Surety unless the collateral was given to Dustin with the express understanding that it was for the benefit of King Surety as well as Dustin.

N81#25. When the debtor has defaulted on its obligation, the creditor is entitled to recover from the surety, unless which of the following is present?
   a. The surety is in the process of exercising its right of exoneration against the debtor.
   b. The debtor has died or become insolvent.
   c. The creditor could collect the entire debt from the debtor’s collateral in his possession.
   d. The surety is a guarantor of collection and the creditor failed to exercise due diligence in enforcing his remedies against the debtor.

N81#26. Dependable Surety Company, Inc., issued a surety bond for value received which guaranteed: (1) completion of a construction contract Mason had made with Lund and (2) payment by Mason of his workmen. Mason defaulted and did not complete the contract. The workers were not paid for their last week’s work. Mason had in fact become insolvent, and a petition in
bankruptcy was filed two months after the issuance of the bond. What is the effect upon Dependable as a result of the above events?

a. If Dependable pays damages to Lund as a result of the default on the contract, Dependable is entitled to recover in the bankruptcy proceedings the entire amount it paid prior to the payment of the general creditors of Mason.
b. If Dependable pays the workers in full, it is entitled to the same priority in the bankruptcy proceedings that the workers would have had.
c. If Dependable has another separate claim against Lund, Dependable may not set it off against any rights Lund may have under this contract.
d. As a compensated surety, Dependable would be discharged from its surety obligation by Mason’s bankruptcy.

N81#27. Marbury Surety, Inc., agreed to act as a guarantor of collection of Madison’s trade accounts for one year beginning on April 30, 1980, and was compensated for same. Madison’s trade debtors are in default in payment of $3,853, as of May 1, 1981. As a result

a. Marbury is liable to Madison without any action on Madison’s part to collect the amounts due.
b. Madison can enforce the guarantee even if it is not in writing since Marbury is a del credere agent.
c. The relationship between the parties must be filed in the appropriate county office since it is a continuing security transaction.
d. Marbury is liable for those debts for which a judgment is obtained and returned unsatisfied.

N81#28. Hargrove borrowed $40,000 as additional working capital for her business from the Old Town Bank. Old Town required that the loan be collateralized to the extent of 60%, and an acceptable surety for the entire amount be obtained. Prudent Surety Company agreed to act as surety on the loan and Hargrove pledged $24,000 of bearer negotiable bonds, which belonged to her husband, with Old Town. Hargrove has defaulted. Which of the following is correct?

a. As a result of the default, Prudent and Hargrove’s husband are cosureties.
b. Old Town must first proceed against Hargrove and obtain a judgment for payment before it can proceed against the collateral.
c. Old Town must first liquidate the collateral before it can proceed against Prudent.
d. Prudent is liable in full immediately upon default by Hargrove, but will upon satisfaction of the debt be entitled to the collateral.

N81#29. Allen was the surety for the payment of rent by Lear under a lease from Rosenthal Rentals. The lease was for two years. A clause in the lease stated that at the expiration of the lease, the lessee had the privilege to renew upon thirty days’ prior written notice or, if the lessee remained in possession after its expiration, it was agreed that the lease was to continue for two years more. There was a default in the payment of rent during the extended term of the lease and Rosenthal is suing Allen for the rent due based upon the guarantee. Allen contends that he is liable only for the initial term of the lease and not for the extended term. Allen is

a. Not liable since it does not appear that a judgment against Lear has been returned unsatisfied.
b. Not liable because there has been a material alteration of the surety undertaking.
c. Not liable because there was a binding extension of time.
d. Liable on the surety undertaking which would include the additional two years.

M81#35. Doral is the surety on a loan made by Nelson to Gordon. Which statement describes Doral’s legal relationship or status among the respective parties?

a. As between Gordon and Doral, Doral has the ultimate liability.
b. Upon default by Gordon and payment by Doral, Doral is entitled to subrogation to the rights of Nelson or to obtain reimbursement from Gordon.
c. Doral is a fiduciary insofar as Nelson is concerned.
d. Doral is not liable immediately upon default by Gordon, unless the agreement so provides.

M81#36. Don loaned $10,000 to Jon, and Robert agreed to act as surety. Robert’s agreement to act as surety was induced by (1) fraudulent misrepresentations made by Don concerning Jon’s financial status and (2) a bogus unaudited financial statement of which Don had no knowledge, and which was independently submitted by Jon to Robert. Which of the following is correct?

a. Don’s fraudulent misrepresentations will not provide Robert with a valid defense unless they were contained in a signed writing.
b. Robert will be liable on his surety undertaking despite the facts since the defenses are personal defenses.
c. Robert’s reliance upon Jon’s financial statements makes Robert’s surety undertaking voidable.
d. Don’s fraudulent misrepresentations provide Robert with a defense which will prevent Don from enforcing the surety undertaking.

M81#37. Welch is a surety on Stanton’s contract to build an office building for Brent. Stanton intentionally abandoned the project after it was 85% completed because of personal animosity which developed toward Brent. Which of the following is a correct statement
concerning the rights or responsibilities of the various parties?

a. Any modification of the contract, however slight and even if beneficial to Welch, will release Welch.
b. Welch would be ordered to specifically perform the completion of the building if Brent sought this remedy.
c. Neither Stanton’s failure to give Welch prior notice of its intention to abandon the project nor its actual abandonment of the project will release Welch.
d. Welch can not engage a contractor to finish the job and obtain from Brent the balance due on the contract.

**M81#38.** Reginald, who is insolvent, defaulted on a loan upon which Jayne was the surety. Edward, the creditor, demanded payment from Jayne of the amount owed by Reginald. The loan was also secured by a mortgage which Edward has the right to foreclose. Which of the following is Jayne’s best legal course of action?

a. Seek specific performance by Reginald.
b. Refuse to pay until Reginald has been petitioned into bankruptcy and the matter has been decided by the trustee in bankruptcy.
c. Pay Edward and resort to the subrogation rights to the collateral.
d. Refuse to pay because Edward must first resort to the collateral.

**M81#39.** Overall, Inc., owns 100% of the stock of Controlled Corporation, each being a separate entity. Overall telephoned the Factory Supply Company and ordered $400 of miscellaneous merchandise. Overall told Factory to ship the supplies to Controlled and Overall would pay for them. Factory did so and now seeks recovery of the price or damages. Which of the following is correct?

a. Overall is a surety.
b. The Statute of Frauds will not bar Factory from recovering from Overall.
c. Controlled is the principal debtor.
d. Overall and Controlled are jointly and severally liable on the contract.

**B. Bankruptcy**

**N84**

Items 26 and 27 are based on the following information:

Frank has been involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. After reducing Frank’s non-exempt property to cash, the following expenses and unsecured claims of creditors remain:

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees incurred to recover property belonging in the bankrupt’s estate</td>
<td>$9,000</td>
</tr>
<tr>
<td>Costs necessary to sell the property of the estate</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Unsecured Claims</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage claims of John Doe, earned as an employee of Frank within 61 days of the filing of the bankruptcy petition</td>
</tr>
<tr>
<td>Income taxes for the two years immediately preceding the filing of the bankruptcy petition</td>
</tr>
</tbody>
</table>

26. If the cash available for distribution is $12,000, what amount(s) will be distributed for expenses?

<table>
<thead>
<tr>
<th>Fees to recover property of the estate</th>
<th>Costs to sell property of the estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $6,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>c. $7,200</td>
<td>$4,800</td>
</tr>
<tr>
<td>d. $9,000</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

27. If the cash available for distribution is $25,000, what amount will be distributed for the income tax claims?

a. $7,000
b. $8,000
c. $10,000
d. $25,000

**N84#28.** The trustee in bankruptcy of a landlord-debtor under a Chapter 7 liquidation

a. Must be elected by the creditors immediately after a bankruptcy petition is filed.
b. May not be appointed by the court after the order for relief has been entered.
c. Must reject the executory contracts of the debtor.
d. May assign the leases of the debtor.

**N84#16.** A debtor will be denied a discharge in bankruptcy if the debtor

a. Failed to timely list a portion of his debts.
b. Unjustifiably failed to preserve his books and records which could have been used to ascertain the debtor’s financial condition.
c. Has negligently made preferential transfers to favored creditors within 90 days of the filing of the bankruptcy petition.
d. Has committed several willful and malicious acts which resulted in bodily injury to others.

**N84#17.** White is a general creditor of Ned. Ned filed a petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. White wishes to have
the bankruptcy court either deny Ned a general discharge or not have his debt discharged. The discharge will be granted and it will include White’s debt even if
a. Ned has unjustifiably failed to preserve the records from which Ned’s financial condition might be ascertained.
b. Ned had received a previous discharge in bankruptcy under the liquidation provisions within six years.
c. White’s debt is unscheduled.
d. White was a secured creditor who was not fully satisfied from the proceeds obtained upon disposition of the collateral.

M84#18. Under the Bankruptcy Code, one of the elements that must be established in order for the trustee in bankruptcy to void a preferential transfer to a creditor who is not an insider is that
a. The transferee-creditor received more than he would have received in a liquidation proceeding under the Bankruptcy Code.
b. Permission was received from the bankruptcy judge prior to the trustee’s signing an order avoiding the transfer.
c. The transfer was in fact a contemporaneous exchange for new value given to the debtor.
d. The transferee-creditor knew or had reason to know that the debtor was insolvent.

M84#19. Bar, a creditor of Sy, has filed an involuntary petition in bankruptcy against Sy. Sy is indebted to six unsecured creditors including Bar for $6,000 each. If Sy opposes the petition, which of the following is correct?
a. Bar must be joined by at least two other creditors in filing the petition.
b. The court must appoint a trustee within ten days after the filing of the petition.
c. Bar may be required to file a bond indemnifying Sy for any losses which Sy may incur.
d. The court may not award attorneys fees to Sy due to its limited authority under the Bankruptcy Code.

M83#21. A voluntary bankruptcy proceeding is available to
a. All debtors provided they are insolvent.
b. Debtors only if the overwhelming preponderance of creditors have not petitioned for and obtained a receivership pursuant to state law.
c. Corporations only if a reorganization has been attempted and failed.
d. Most debtors even if they are not insolvent.

M83#22. An involuntary petition in bankruptcy
a. Will be denied if a majority of creditors in amount and in number have agreed to a common law composition agreement.
b. Can be filed by creditors only once in a seven-year period.
c. May be successfully opposed by the debtor by proof that the debtor is solvent in the bankruptcy sense.
d. If not contested will result in the entry of an order for relief by the bankruptcy judge.

M83#23. A bankrupt who has voluntarily filed for and received a discharge in bankruptcy
a. Will receive a discharge of any and all debts owed by him as long as he has not committed a bankruptcy offense.
b. Can obtain another voluntary discharge in bankruptcy after five years have elapsed from the date of the prior discharge.
c. Must surrender for distribution to the creditors amounts received as an inheritance if the receipt occurs within 180 days after filing of the petition.
d. Is precluded from owning or operating a similar business for two years.

M83#24. Hard Times, Inc., is insolvent. Its liabilities exceed its assets by $13 million. Hard Times is owned by its president, Waters, and members of his family. Waters, whose assets are estimated at less than a million dollars, guaranteed the loans of the corporation. A consortium of banks is the principal creditor of Hard Times, having loaned it $8 million, the bulk of which is unsecured. The banks decided to seek reorganization of Hard Times and Waters has agreed to cooperate. Regarding the proposed reorganization
a. Waters’ cooperation is necessary since he must sign the petition for a reorganization.
b. If a petition in bankruptcy is filed against Hard Times, Waters will also have his personal bankruptcy status resolved and relief granted.
c. Only a duly constituted creditors committee may file a plan of reorganization of Hard Times.
d. Hard Times will remain in possession unless a request is made to the court for the appointment of a trustee.

N82#16. An otherwise valid petition for involuntary bankruptcy has been filed against Mohawk Corporation. This will be sufficient to obtain an order for relief against Mohawk provided
a. Mohawk is generally not paying debts as they become due.
b. A custodian has been appointed to take charge of substantially all of Mohawk’s debts within four months of filing.
c. The creditor or creditors can establish that Mohawk is bankrupt in the bankruptcy sense.
d. The majority of creditors join in the filing if there are more than two creditors involved.
Business Law

M82#18. Since the passage of the Bankruptcy Reform Act of 1978, voluntary bankruptcy proceedings have become increasingly popular with debtors. The new law
a. Increases availability and eases filing.
  b. Increases the amount of property which is exempt.
  c. Reduces the number of creditors necessary for filing.
  d. Accepts solvency in the equity sense as the criterion for determining bankruptcy status.

M82#19. Chapter 11 of the Bankruptcy Reform Act of 1978 deals with reorganizations. This Chapter
a. Is exclusively available to corporations.
  b. Permits the debtor-in-possession to continue to operate the business in the same manner as a Chapter 11 trustee.
  c. Provides for filing of voluntary petitions but prohibits the filing of involuntary petitions.
  d. Provides separate procedures for corporations with publicly held securities.

M82#18. Mac, doing business as Mac's Restaurant, has an involuntary petition in bankruptcy filed against him. Which of the following is a correct legal statement regarding such a filing?
  a. Mac has the right to controvert the validity of the petition and if Mac is successful, the petition will be dismissed and Mac may recover his costs including a reasonable attorney's fee.
  b. The filing of the petition by a majority of the creditors creates a binding presumption that Mac is insolvent.
  c. A single creditor may file the petition regardless of the number of creditors if its provable claim exceeds $7,500.
  d. A trustee is appointed upon the filing of the petition and is vested by operation of law with the bankrupt's title as of the date of the filing.

M82#19. An audit client is in serious financial trouble. On November 1, 1981, several creditors filed an involuntary petition in bankruptcy. Which of the following is correct?
  a. As long as the client generally can meet current debts as they mature, the court will deny relief against the client in a bankruptcy proceeding.
  b. If the client creates a new corporation and transfers most of its assets to the newly created corporation, it can avoid bankruptcy.
  c. As long as the client's assets, at fair value, exceed its liabilities, the creditors' petition will be denied.
  d. Unless the client commits an act of bankruptcy, the creditors can not force the client into bankruptcy.

M82#20. The Bankruptcy Reform Act of 1978 provides that certain allowed expenses and claims are entitled to a priority. Which of the following is not entitled to such a priority?
  a. Claims of governmental units for taxes.
  b. Wage claims, but to a limited extent.
  c. Rents payable within the four months preceding bankruptcy, but to a limited extent.
  d. Unsecured claims for contributions to employee benefit plans, but to a limited extent.

M82#21. Which of the following was a significant reform made in the reorganization provisions of the Bankruptcy Reform Act of 1978?
  a. Separate treatment of publicly held corporations under its provisions.
  b. Elimination of the separate and competing procedures contained in the various chapters of the prior Bankruptcy Act.
  c. Elimination of participation in bankruptcy reorganizations by the Securities and Exchange Commission.
  d. The exclusion from its jurisdiction of partnerships and other noncorporate entities.

M82#22. Clark is a surety on a $100,000 obligation owed by Thompson to Owens. The debt is also secured by $50,000 mortgage to Owens on Thompson's factory. Thompson is in bankruptcy. Clark has satisfied the debt. Clark is
  a. Only entitled to the standing of a general creditor in bankruptcy.
  b. A secured creditor to the extent of the $50,000 mortgage and a general creditor for the balance.
  c. Entitled to nothing in bankruptcy since this was a risk he assumed.
  d. Not entitled to a priority in bankruptcy, even though Owens could validly claim it.

M81#40. A client has joined other creditors of the Martin Construction Company in a composition agreement seeking to avoid the necessity of a bankruptcy proceeding against Martin. Which statement describes the composition agreement?
  a. It provides a temporary delay, not to exceed six months, insofar as the debtor's obligation to pay the debts included in the composition.
  b. It does not discharge any of the debts included until performance by the debtor has taken place.
  c. It provides for the appointment of a receiver to take over and operate the debtor's business.
  d. It must be approved by all creditors.
Selected Questions

M81#41. In a bankruptcy proceeding, the trustee
   a. Must be an attorney admitted to practice in the federal district in which the bankrupt is located.
   b. Will receive a fee based upon the time and fair value of the services rendered, regardless of the size of the estate.
   c. May not have had any dealings with the bankrupt within the past year.
   d. Is the representative of the bankrupt’s estate and as such has the capacity to sue and be sued on its behalf.

M81#43. If a secured party’s claim exceeds the value of the collateral of a bankrupt, he will be paid the total amount realized from the sale of the security and will
   a. Not have any claim for the balance.
   b. Become a general creditor for the balance.
   c. Retain a secured creditor status for the balance.
   d. Be paid the balance only after all general creditors are paid.

M81#44. In order to establish a preference under the federal bankruptcy act, which of the following is the trustee required to show where the preferred party is not an insider?
   a. That the preferred party had reasonable cause to believe that the debtor was insolvent.
   b. That the debtor committed an act of bankruptcy.
   c. That the transfer was for an antecedent debt.
   d. That the transfer was made within 60 days of the filing of the petition.

V. Government Regulation of Business

A. Regulation of Employment

M85#30. Silk was employed by Rosco Corp. as a chauffeur. While in the course of employment, Silk was involved in an automobile accident with Lake who was employed by Stone Corp. as a truck driver. While making a delivery for Stone, Lake negligently drove through a red light causing the accident with Silk. Both Silk and Lake have received workers’ compensation benefits as a result of the accident. Silk
   a. Is precluded from suing Lake since both are covered under workers’ compensation laws.
   b. Is precluded from suing Stone if Stone complied fully with the state’s workers’ compensation laws.
   c. Can recover in full against Lake only, but must reimburse the workers’ compensation carrier to the extent the recovery duplicates benefits already obtained under workers’ compensation laws.
   d. Can recover in full against Lake or Stone, but must reimburse the workers’ compensation carrier to the extent the recovery duplicates benefits already obtained under workers’ compensation laws.

M85#31. Which of the following statements is correct regarding social security taxes?
   a. The annual contributions made by a self-employed person with net earnings of $30,000 in 1985 will be the same as the combined contributions made by an employee and employer on that same amount.
   b. A self-employed person is subject to social security taxes based on that person’s gross earnings from self-employment.
   c. An employer who fails to withhold and pay the employee’s portion of social security taxes remains primarily liable for the employee’s share.
   d. An individual who receives net earnings from self-employment of $30,000 and wages of $30,000 in 1985 will be subject to social security taxes on $60,000.

M85#32. 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. Permits the employer to take a credit against the federal tax if contributions are made to a state unemployment fund.
   d. Permits an employee to receive unemployment benefits which are limited to the contributions made to that employee’s account.

M84#37. Federal unemployment taxes
   a. Are deductible by an employee on his individual tax return.
   b. Are deductible as a business expense on the federal income tax return of a corporate employer.
   c. May be offset by a credit equal to the amount of the federal tax liability if the employer contributes to an approved state unemployment fund.
   d. Are imposed on the employer and employee.
N84#38. Which of the following is a violation of the equal employment opportunity laws or civil rights laws?
   a. Discrimination by an employer on the basis of national origin where there are bona fide occupational qualifications reasonably necessary to normal operations.
   b. Denial of employment to individuals due to their inability to obtain security clearance where the employer is working under government security programs.
   c. Hiring on the basis of a professionally developed test that bears a relationship to the job when a less discriminatory effect on employment is not feasible.
   d. Referral by an employment agency based on race, in response to an employer’s specific request to refer based on race.

M84#28. Wilk, an employee of Young Corp., was injured by the negligence of Quick, an independent contractor. The accident occurred during regular working hours and in the course of employment. If Young has complied with the state’s workers’ compensation laws, which of the following is correct?
   a. Wilk is barred from suing Young or Quick for negligence.
   b. Wilk will be denied workers’ compensation if he was negligent in failing to adhere to the written safety procedures.
   c. The amount of damages Wilk will be allowed to recover from Young will be based on comparative fault.
   d. Wilk may obtain workers’ compensation benefits and also properly maintain an action against Quick.

N84#39. Which of the following is required in order for an employee to recover under a compulsory state worker’s compensation statute?
   a. The employee must be free from any wrongdoing.
   b. The injury must arise out of the negligence of the employer or fellow employee.
   c. The injury must arise out of and in the course of employment.
   d. The injury must occur while the employee is engaged in interstate commerce.

M84#39. Hicks is employed as executive sales manager by Foster Fabrics. She received a salary of $30,000 in 1982. In addition, she earned $15,000 net in 1982 as a freelance photographer. As a result of the above earnings for 1982 and the application of the provisions of the Federal Insurance Contributions Act, Hicks
   a. Owed nothing since her salary was fully subjected to withholding of FICA tax by Foster.
   b. Was required to pay a self-employment tax on the difference between the FICA tax base amount and $30,000.
   c. Was required to pay both an employer and employee FICA tax on the $15,000.
   d. Was required to ascertain the gross amount of income from the freelance photography and compute the FICA tax owed on that amount.

N84#40. Social security benefits are available
   a. To a qualifying individual or his family only upon such individual’s death or retirement.
   b. Only to those who have taxable income under a maximum limitation.
   c. To an otherwise qualifying individual who is also receiving payments under a private pension plan.
   d. To children of a deceased worker who was covered under social security, until such children reach age 25 or complete their education, whichever occurs first.

M84#40. The Equal Employment Opportunity Commission
   b. Has the power to file a civil suit in federal district court and to represent a person charging a violation of the act.
   c. Has no jurisdiction over the Civil Rights Act.
   d. Has authority to issue cease and desist orders in those cases where there have been repeated violations.

N84#41. There are federal and state unemployment taxes. Regarding the Federal Unemployment Tax Act
   a. Payment of the tax is shared equally by the employer and the employee.
   b. Employees who earn less than $7,000 are exempt from coverage.
   c. Benefits to an employee can not exceed the amount contributed to his account.
   d. A credit is generally available for contributions made by the employer to state unemployment funds.
M83#34. Fairfax was employed by Wexford Manufacturing Company as a salaried salesman. While Fairfax was driving a company car on a sales call, a truck owned and operated by Red Van Lines ran a stop light and collided with Fairfax's car. Fairfax applied for and received worker's compensation for the injuries sustained. As a result of receiving worker's compensation, Fairfax
a. Must assign any negligence cause of action to Wexford pursuant to the doctrine of respondent superior.
b. Is precluded from suing Red for negligence because of the worker's compensation award.
c. Can recover in full against Red for negligence, but must return any duplication of the worker's compensation award.
d. Can recover in full against Red for negligence and retain the full amounts awarded under worker's compensation.

M83#35. Which of the following is a part of the Social Security law?
a. A self-employed person must contribute an annual amount which is less than the combined contributions of an employee and his or her employer.
b. Upon the death of an employee prior to his retirement, his estate is entitled to receive the amount attributable to his contributions as a death benefit.
c. Social Security benefits must be fully funded and payments, current and future, must constitutionally come only from Social Security taxes.
d. Social Security benefits are taxable as income when they exceed the individual's total contributions.

N82#26. Which of the following regarding workers' compensation is correct?
a. A purpose of workers' compensation is for the employer to assume a definite liability in exchange for the employee giving up his common law rights.
b. It applies to workers engaged in or affecting interstate commerce only.
c. It is optional in most jurisdictions.
d. Once workers' compensation has been adopted by the employer, the amount of damages recoverable is based upon comparative negligence.

N82#27. Which of the following would be the employer's best defense to a claim for workers' compensation by an injured route salesman?
a. A route salesman is automatically deemed to be an independent contractor, and therefore excluded from workers' compensation coverage.
b. The salesman was grossly negligent in carrying out the employment.
c. The salesman's injury was caused primarily by the negligence of an employee.
d. The salesman's injury did not arise out of and in the course of employment.

N82#28. Which of the following employees are exempt from the minimum and maximum hour provisions of the Fair Labor Standards Act?
a. Children.
b. Railroad and airline employees.
c. Members of a union recognized as the bargaining agent by the National Labor Relations Board.
d. Office workers.

N82#29. Under the Fair Labor Standards Act the Secretary of Labor does not have the power to
a. Issue subpoenas compelling attendance by a witness and the production of records by an employer.
b. Conduct investigations regarding practices subject to the Act.
c. Issue a wage order which requires an employer to pay wages found to be due and owing under the Act.
d. Issue injunctions to restrain obvious violations of the Act.

N82#34. Under the Fair Labor Standards Act, certain employment of children is considered oppressive and is prohibited. Which of the following is not a legal exception to the Act?
a. Employment in agriculture outside of school hours.
b. Employment of children under sixteen by a parent.
c. Newspaper delivery.
d. After school part-time work in the fast-food industry.

N81#30. The social security tax does not apply to which of the following?
a. Payments on account of sickness including medical and hospital expenses paid by the employer.
b. Compensation paid in forms other than cash.
c. Self-employment income of $1,000.
d. Bonuses and vacation time pay.

M81#58. Stephens is an employee of the Jensen Manufacturing Company, a multi-state manufacturer of roller skates. The plant in which he works is unionized and Stephens is a dues paying union member. Which
statement is correct insofar as the Federal Fair Labor Standards Act is concerned?
   a. The Act allows a piece-rate method to be employed in lieu of the hourly-rate method where appropriate.
   b. Jensen is permitted to pay less than the minimum wage to employees since they are represented by a bona fide union.
   c. The Act sets the maximum number of hours that an employee can work in a given day or week.
   d. The Act excludes from its coverage the employees of a labor union.

M81#59. The Social Security Act provides for the imposition of taxes and the disbursement of benefits. Which of the following is a correct statement regarding these taxes and disbursements?
   a. Only those who have contributed to Social Security are eligible for benefits.
   b. As between an employer and its employee, the tax rates are the same.
   c. A deduction for federal income tax purposes is allowed the employee for Social Security taxes paid.
   d. Social Security payments are includable in gross income for federal income tax purposes unless they are paid for disability.

M81#60. Musgrove Manufacturing Enterprises is subject to compulsory worker's compensation laws in the state in which it does business. It has complied with the state's worker's compensation provisions. State law provides that where there has been compliance, worker's compensation is normally an exclusive remedy. However, the remedy will not be exclusive if
   a. The employee has been intentionally injured by the employer personally.
   b. The employee dies as a result of his injuries.
   c. The accident was entirely the fault of a fellow-servant of the employee.
   d. The employer was only slightly negligent and the employee's conduct was grossly negligent.

B. Federal Securities Acts

M85#28. Securities available under a private placement made pursuant to Regulation D of the Securities Act of 1933
   a. Must be sold to accredited institutional investors.
   b. Must be sold to less than 25 non-accredited investors.
   c. Can not be the subject of an immediate reoffering to the public.
   d. Can not be subject to the payment of commissions.

N84#41. Which of the following statements concerning the scope of section 10(b) of the Securities Exchange Act of 1934 is correct?
   a. It applies to purchases as well as sales of securities in interstate commerce.
   b. There is an exemption from its application for securities registered under the Securities Act of 1933.
   d. In order to come within its scope, a transaction must have taken place on a national stock exchange.

N84#42. Which of the following is subject to the registration requirements of the Securities Act of 1933?
   a. Public sale of its bonds by a municipality.
   b. Public sale by a corporation of its negotiable five-year notes.
   c. Public sale of stock issued by a common carrier regulated by the Interstate Commerce Commission.
   d. Issuance of stock by a corporation to its existing stockholders pursuant to a stock split.

N84#44. When there is evidence of a violation of the federal securities laws, the Securities and Exchange Commission lacks the power to
   a. Subpoena witnesses.
   b. Compel the production of books and records anywhere in the United States.
   c. Order an administrative hearing to determine responsibility for the violation and impose certain sanctions.
   d.Prosecute criminal cases.
Selected Questions

N84#45. Cooke, in his capacity as president of Tool Corp., was convicted of willful violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The sanctions under both acts
   a. Permit the imposition of only a fine.
   b. Permit the imposition of both a fine and a term of imprisonment.
   c. Are different since criminal sanctions are excluded from the Securities Exchange Act of 1934.
   d. Are different since criminal sanctions are excluded from the Securities Act of 1933.

M84#29. A requirement of a private action to recover damages for violation of the registration requirements of the Securities Act of 1933 is that
   a. The plaintiff has acquired the securities in question.
   b. The issuer or other defendants commit either negligence or fraud in the sale of the securities.
   c. A registration statement has been filed.
   d. The securities be purchased from an underwriter.

M84#30. Which of the following financing methods will be exempt from the registration requirements of the Securities Act of 1933?
   a. Direct public offering of stock to potential investors without the use of an underwriter.
   b. Interstate marketing of securities by a subsidiary which is engaged in intrastate commerce.
   c. Sale of long-term notes to a consortium of local banks.
   d. Public sale of nonconvertible bonds to investors.

M84#33. Which of the following statements is correct with respect to criminal prosecution under the Securities Acts?
   a. Reckless disregard for the truth is a sufficient basis for a criminal conviction.
   b. Personal monetary gain from the alleged criminal conduct is required in order to be convicted.
   c. The anti-fraud provisions of the Securities Acts are the only basis upon which a person can be indicted and convicted.
   d. Corporations are not subject to criminal prosecution.

M84#34. The anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934
   a. Are the same insofar as the transactions to which they apply.
   b. Are unavailable to plaintiffs who are unable to establish diversity of citizenship and a minimum of $10,000 monetary damages.
   c. Contain criminal sanctions against those who engage in fraudulent activities.
   d. Contain remedies which are mutually exclusive of each other.

N83#43. Although the Securities and Exchange Commission has broad powers in conducting a formal investigatory proceeding, the SEC cannot
   a. Impose monetary penalties without court proceedings.
   b. Compel a witness to appear.
   c. Subpoena records.
   d. Conduct its investigations secretly.

N83#44. The president of XK Corporation has been charged by the Securities and Exchange Commission with a criminal violation of the Securities Exchange Act of 1934. Under these circumstances
   a. The SEC may elect to prosecute the case itself or turn the case over to the Justice Department.
   b. It is irrelevant whether the president had knowledge of his wrongdoing in determining whether to impose a fine or prison term.
   c. The SEC must elect between civil and criminal action but may not pursue both.
   d. A fine or prison term or both may be imposed.

N82#31. Which of the following securities or security transactions is automatically exempt under the Securities Act of 1933 from the Act’s registration requirements?
   a. An offering of $3,000,000 or less of stock to 25 or fewer persons.
   b. A $10 million offering of first mortgage bonds to the public.
   c. An exchange by a corporation of its own securities with existing shareholders without payment of brokerage commissions.
   d. Sale by a director of her shares of stock providing that she owns less than 10% of the corporation’s stock and that the sale is on a registered stock exchange.
**Business Law**

**M85#32.** Which of the following is required under the Securities Exchange Act of 1934 or the SEC's reporting requirements issued pursuant thereto?

a. Current reporting by issuers of registered securities of certain specified corporate and financial events within ten days after the close of the month in which they occur.

b. Quarterly audited financial reports and statements by those corporations listed on a national exchange.

c. Reporting by issuers of securities which are traded over-the-counter, but only if the securities are actively traded.

d. Annual filing of audited financial reports by all corporations engaged in interstate commerce.

**M85#33.** Insofar as the Securities Act of 1933 and the Securities Exchange Act of 1934 are concerned with fraud

a. The Acts are identical with respect to proscribing fraudulent transactions.

b. The anti-fraud provisions are contained exclusively in the 1934 Act.

c. The 1933 Act does not require proof of scienter in all circumstances whereas the 1934 Act does.

d. Only the 1933 Act contains criminal sanctions against those found to be guilty of fraud.

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**VI. Uniform Commercial Code**

**A. Commercial Paper**

**M85#33.** The following instrument was received by Kerr:

Madison, Wisconsin April 5, 1985

Sixty days after date pay to the order of Donald Kerr, one hundred and fifty dollars ($150). Value received and charge the trade account of Olympia Sales Corp., N.Y.

Olympia Sales Corp.

To: New City Bank, by Carl Farr
U.N. Plaza,
New York, N.Y. President

The instrument is a

a. Negotiable time draft.

b. Check.

c. Promissory note.

d. Trade acceptance.

**M85#34.** Jason contracted to sell his business to Farr. Upon execution of the contract by Farr, he delivered a note in lieu of earnest money which recited the nature of the transaction and indicated that it was payable on the date of the closing which was to be determined by the mutual consent of the parties. The note is

a. Non-negotiable because no consideration is given.

b. Non-negotiable because of the recitation of the transaction which gave rise to it.

c. Non-negotiable since it is not payable at a definite time.

d. Negotiable.

**M85#35.** A holder in due course will take free of which of the following defenses?

a. A wrongful filling-in of the amount payable which was omitted from the instrument.

b. Duress of a nature which renders the obligation of the party a nullity.

c. Infancy to the extent that it is a defense to a simple contract.

d. Discharge of the maker in bankruptcy.

**M85#36.** Your client, MDS Discount Services, Inc., purchased the following instrument from John Cross on February 15, 1985. Cross had received it in connection with the sale to Dann Corp. of real property he owned located in Utah. Cross endorsed it in blank and received $24,000 from MDS.
Selected Questions

$26,000.00 Boston, Massachusetts February 2, 1985

Sixty days after date, I promise to pay to the order of John Cross Twenty Six Thousand & 00/100 Dollars at the Second National Bank of Provo, Utah.

Value received with interest at the rate of 14% per annum. This instrument arises out of the sale of real estate located in the state of Utah. It is further agreed that this instrument is:

1. Subject to all implied and constructive co-litigations.
2. Secured by a first mortgage given as per the sale of the real estate mentioned above.
3. To be paid out of funds deposited in the City Bank of Wabash, Illinois.

Dann Corp.
by Jean Brown
President

The instrument is
a. Non-negotiable due to the language contained in clause number 1.

b. Non-negotiable since it incorporates by reference the terms of the mortgage indicated in clause number 2.

c. Negotiable since it contains the words "value received" and specifies the required recitation of the transaction out of which it arose.

d. Negotiable despite the language contained in clauses numbered 1, 2, and 3.

M85#39. A person who endorsed a check "without recourse"

a. Has the same liability as an accommodation endorser.
b. Only negates his liability insofar as prior parties are concerned.
c. Gives the same warranty protection to his transferee as does a special or blank endorser.
d. Does not promise or guarantee payment of the instrument upon dishonor even if there has been a proper presentment and proper notice has been given.

N84#46. Which of the following is covered under the UCC Article on commercial paper?

a. An investment security.
c. A promissory note payable 10 days after presentment.
d. A negotiable warehouse receipt.

N84#47. Sinka Corp. has the following instrument in its possession:

<table>
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<th>No. 121</th>
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<tr>
<td>Oct. 3, 1984</td>
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<td>51-109</td>
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Pay to the order of Sinka Corp. $2,500.00

Two Thousand Five Hundred and 00/100 Dollars

Fifteen days after presentment

Bocca Trust Company
Portland, Oregon

Memo: For purchase of stock

Ludwig Bond

The above instrument is
a. A draft.
b. Nonnegotiable.
c. A check.
d. A trade acceptance.

M85#38. In connection with a check and a promissory note, which of the following is correct?

a. A promissory note may only be made payable to the order of a named payee.
b. A promissory note may only be payable at a stated time in order to meet the requirements for negotiability.
c. A check may be made payable upon the happening of an event uncertain as to the time of occurrence without affecting its negotiability.
d. A check may be made payable to the order of the drawer or to bearer.

M85#37. Bond fraudulently induced Kent to make a note payable to Baker to whom Bond was indebted. Bond delivered the note to Baker. Baker negotiated the instrument to Monk who purchased it with knowledge of the fraud and after it was overdue. If Baker qualifies as a holder in due course, which of the following is correct?

a. Monk can personally qualify as a holder in due course.
b. Monk has the standing of a holder in due course through Baker.
c. Monk can not collect because he purchased with knowledge of the fraud and after it was overdue.
d. Kent can successfully assert the defense of fraud against Monk.
N84#48. The following instrument has been received by your client:

July 31, 1984
To: Sam Snyder
P.O. Box 3
Canton, Ohio
Pay to the order of Ted Tint two thousand dollars.

Larry Lark

Which of the following is correct?
   a. As Sam Snyder is the drawee, he is secondarily liable on the instrument.
   b. As Sam Snyder is the drawer, he is primarily liable on the instrument.
   c. The instrument is a negotiable note.
   d. The instrument is payable on demand.

N84#49. In order to negotiate bearer paper, one must
   a. Deliver and endorse the paper.
   b. Deliver the paper.
   c. Endorse the paper.
   d. Endorse and deliver the paper with consideration.

N84#50. Which of the following on the face of an otherwise negotiable instrument will affect the instrument’s negotiability?
   a. The instrument contains a promise to provide additional collateral if there is a decrease in value of the existing collateral.
   b. The instrument is payable six months after the death of the maker.
   c. The instrument is payable at a definite time subject to an acceleration clause in the event of a default.
   d. The instrument is postdated.

N84#51. Sample has in his possession a negotiable instrument which was originally payable to the order of Block. It was transferred to Sample by a mere delivery by Cox, who took it from Block in good faith in satisfaction of an antecedent debt. The back of the instrument reads as follows, “Pay to the order of Cox in satisfaction of my prior purchase of a desk, signed Block.” Which of the following is correct?
   a. Sample has the right to assert Cox’s rights, including his standing as a holder in due course and also has the right to obtain Cox’s signature.
   b. Block’s endorsement was a special endorsement, thus Cox’s signature was not required in order to negotiate it.
   c. Sample is a holder in due course.
   d. Cox’s taking the instrument for an antecedent debt prevents him from qualifying as a holder in due course.

N84#52. Which of the following is a valid defense against a holder in due course of a negotiable instrument?
   a. Execution of the instrument by one without authority to sign the instrument.
   b. Fraudulent statements made to the drawer as to the value of the consideration given for the instrument.
   c. Duress on the drawer which renders the instrument voidable at the drawer’s option.
   d. Delivery of the instrument subject to a condition precedent which has yet to be performed.

M84

Items 36 through 45 involve commercial paper under Article 3 of the Uniform Commercial Code.

36. Assuming each of the following instruments is negotiable, which qualifies as commercial paper?
   b. Investment securities endorsed in blank.
   c. Foreign currency.
   d. A foreign draft.

37. Assuming each of the following is negotiable, which qualifies as a draft?
   b. A trade acceptance.
   c. A certificate of deposit.
   d. A demand promissory note.

38. The requirements in order for an instrument to qualify as negotiable commercial paper
   a. Are the same as the requirements for a bill of lading.
   b. Permit some substitution or variance from the literal language of the UCC.
   c. May be satisfied by a statement in the instrument that it is to be considered negotiable despite its omission of one or more requirements.
   d. May be waived by the parties in a signed writing.
39. Your client has in its possession the following instrument:

<table>
<thead>
<tr>
<th>$700.00</th>
<th>Provo, Utah</th>
<th>June 1, 1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thirty days after date I promise to pay to the order of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seven hundred Dollars</td>
<td></td>
<td></td>
</tr>
<tr>
<td>at Boise, Idaho</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value received with interest at the rate of ten percent per annum. This instrument is secured by a conditional sales contract.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. 20</td>
<td>Due July 1, 1983</td>
<td>Lee Davis</td>
</tr>
</tbody>
</table>

This instrument is
a. A negotiable time draft.
b. A non-negotiable note since it states that it is secured by a conditional sales contract.
c. Not negotiable until July 1, 1983.
d. A negotiable bearer note.

40. The difference between an assignment to a good faith purchaser and negotiation to a holder in due course is
a. That the holder in due course obtains the instrument free of the defense of lack of consideration whereas one who takes as an assignee does not.
b. Mainly procedural in nature.
c. Primarily important insofar as the methods of transfer are concerned.
d. Relatively unimportant from a legal standpoint.

41. Ed Moss has a negotiable draft in his possession. The draft was originally payable to the order of John Davis. The instrument was endorsed as follows:

(1) Carl Bass
(2) John Davis
(3) Pay to the order of Nix & Co.
(4) Pay to Ed Moss, without recourse, Nix & Co.
   per Jane Kirk, President
(5) For deposit, Ed Moss

Which of the following is correct regarding the above endorsements?

a. Number 1 prevents further negotiation since Bass is not the payee.
b. Number 2 does not change the instrument to bearer paper since it was originally payable to the order of Davis.
c. Number 4 eliminates all the contractual liability of the endorser.
d. Number 5 prevents any further negotiation.

42. In order to be a holder of a bearer negotiable instrument, the transferee must
a. Give value for the instrument.
b. Have physical possession of the instrument.
c. Take the instrument before receipt of notice of a defense.
d. Take in good faith.

43. Which of the following will not constitute value in determining whether a person is a holder in due course?

a. The taking of a negotiable instrument for a future consideration.
b. The taking of a negotiable instrument as security for a loan.
c. The giving of one's own negotiable instrument in connection with the purchase of another negotiable instrument.
d. The performance of services rendered the payee of a negotiable instrument who endorses it in payment for services.

44. Which of the following defenses may be successfully asserted by the maker against a holder in due course?

a. Wrongful filling in of an incomplete instrument by a prior holder.
b. Total failure to perform the contractual undertaking for which the instrument was given.
c. Fraudulent misrepresentations as to the consideration given by a prior holder in exchange for the negotiable instrument.
d. Discharge of the maker of the instrument in bankruptcy proceedings.

45. Regarding certification of a check,

a. Certification by a bank constitutes an acceptance of the check.
b. Certification of a check obtained by the drawer releases the drawer.
c. A bank is obligated to certify a customer's check if a holder demands certification and there are sufficient funds in the drawer's account.
d. If a holder obtains certification of a check, all prior endorsers are discharged, but the drawer remains liable.
**N83#49.** Weber had a negotiable instrument in his possession which he had received in payment of certain equipment he had sold to Roth Merchandising. The instrument was originally payable to the order of Martin Burns or bearer. It was endorsed specially by Burns to Roth who in turn negotiated it to Weber via a blank endorsement. The instrument in question, along with some cash and other negotiable instruments, was stolen from Weber on October 1, 1983. Which of the following is correct?

a. The theft constitutes a common law conversion which prevents anyone from obtaining a better title to the instrument than the owner.

b. A holder in due course will prevail against Weber's claim to the instrument.

c. Once an instrument is bearer paper it is always bearer paper.

d. Weber's signature was necessary in order to further negotiate the instrument.

**N82**

**Items 35 and 37** concern instruments which Alex & Co. has in its possession:

35.

**September 2, 1982**

I, Henry Hardy, do hereby acknowledge my debt to Walker Corporation arising out of my purchase of soybeans and promise to pay to Walker or to its order, SIX HUNDRED DOLLARS, thirty days after presentment of this instrument to me at my principal place of business.

*Henry Hardy*

Re: $600.00 - Soybean purchase

The above instrument is

a. Nonnegotiable.

b. A negotiable promissory note.

c. A trade acceptance.

d. A negotiable bill of lading.

37.

**October 5, 1982**

To: Henry Futterman Suppliers  
281 Cascade Boulevard  
Spokane, Washington 99208  

$950.00

Pay to the order of Alex & Co.  
Nine hundred fifty and 00/100 dollars  
one month after acceptance.  
Alex & Co.

By *Charles Alex*  
Managing Partner

Alex & Co.  
264 Liberty Avenue  
Philadelphia, Pa. 19117  

Accepted by:  
*Laura Futterman Trees*  
Henry Futterman Suppliers  
Date: October 15, 1982

The above instrument is

a. Nonnegotiable since the payee is also the drawer.

b. A time promissory note.

c. A trade acceptance which imposes primary liability upon Henry Futterman Suppliers after acceptance.

d. A negotiable investment security under the Uniform Commercial Code.

**N82#38.** Kirk made a check payable to Haskin's order for a debt she owed on open account. Haskin negotiated the check by a blank indorsement to Carlson who deposited it in his checking account. The bank returned the check with the notation that payment was refused due to insufficient funds. Kirk is insolvent. Under the circumstances
Selected Questions

a. Kirk has a real defense assertable against all parties including Carlson, a holder in due course.
b. If Kirk files for bankruptcy, Haskin or Carlson could successfully assert that there had been an assignment of whatever funds were in Kirk’s checking account.
c. If there is a proper presentment, and notice is properly given by Carlson to Haskin, Carlson may recover the amount of the check from Haskin.
d. Haskin or Carlson can correctly assert the standing of a secured creditor.

N82#39. An instrument complies with the requirements for negotiability contained in the Commercial Paper Article of the Uniform Commercial Code. The instrument contains language expressly acknowledging the receipt of $10,000 by the First Bank of Grand Rapids and an agreement to repay principal with interest at 15% one year from date. This instrument is
a. Nonnegotiable because of the additional language.
b. A negotiable certificate of deposit.
c. A banker’s draft.
d. A banker’s acceptance.

N82#40. Below is a note which your client, Robinson Real Estate, Inc., obtained from Grant in connection with Grant’s purchase of a homesite located in Bangor, Maine. The note was given for the balance due on the purchase and was secured by a first mortgage on the homesite.

$17,000.00
Bangor, Maine
November 1, 1982

For value received, five years after date, I promise to pay to the order of Robinson Real Estate, Inc., SEVENTEEN THOUSAND and 00/100 DOLLARS with interest at 15% compounded annually until fully paid. This instrument arises out of the sale of land located in Maine and the law of Maine 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. Purchaser will pay the costs of collection including attorney’s fees upon default.
2. Purchaser may repay the amount outstanding on any anniversary date of this note.
3. This note is subject to such implied conditions as are applicable to such notes.

Robert Grant

This note is a
a. Nonnegotiable promissory note since it is secured by a first mortgage.
b. Nonnegotiable promissory note since it permits prepayment and requires the maker’s payment of the costs of collection and attorney’s fees.
c. Negotiable promissory note.
d. Negotiable investment security under the Uniform Commercial Code.

N82#41. Ash Company has in its possession the following note:

October 15, 1982

I, Joseph Gorman, promise to pay or deliver to Harold Smalley or to his order ONE THOUSAND DOLLARS ($1,000) or at his option to deliver an amount of stock in the Sunrise Corporation which, on the due date of this instrument, is worth not less than ONE THOUSAND DOLLARS ($1,000). This note is due and payable on the 1st of November, 1982.

Joseph Gorman

This note is
a. Not commercial paper, but instead a negotiable investment security.
b. A negotiable promissory note since it is payable to Smalley’s order and contains an unconditional promise to pay $1,000 if the holder so elects.
c. Nonnegotiable since it gives Smalley the option to take stock instead of cash.
d. Nontransferable.

N82#42. The following three indorsements appear on the back of a negotiable promissory note made payable to Harold Dawson. The note is in the possession of Maxim Company.

Pay to James Edwards
Harold Dawson
Without Recourse
James Edwards
Gilbert Olsen

The instrument has been dishonored after due presentment by Maxim. Proper notice of dishonor has
been given to all parties. Which of the following is correct?

a. James Edwards's signature on the instrument was not necessary.
b. James Edwards has effectively negated all warranty liability to any subsequent party except Gilbert Olsen.
c. James Edwards has neither contractual nor warranty liability as a result of his indorsing without recourse.
d. Gilbert Olsen's signature was necessary to effectively negotiate to Maxim.

**N82#43.** Dodger fraudulently induced Tell to issue a check to his order for $900 in payment for some nearly worthless securities. Dodger took the check and artfully raised the amount from $900 to $1,900. He promptly negotiated the check to Bay who took it in good faith and for value. Tell, upon learning of the fraud, issued a stop order to its bank. Which of the following is correct?

a. Dodger has a real defense which will prevent any of the parties from collecting anything.
b. The stop order was ineffective against Bay since it was issued after the negotiation to Bay.
c. Bay as a holder in due course will prevail against Tell but only to the extent of $900.
d. Had there been no raising of the amount by Dodger, the bank would be obligated to pay Bay despite the stop order.

**N82#51.** A holder in due course will take an instrument free from which of the following defenses?

a. Discharge in insolvency proceedings.
b. Infancy of the maker or drawer.
c. Claims of ownership on the part of other persons.
d. The forged signature of the maker or drawer.

**N82#60.** Drummond broke into the Apex Drug Store and took all of the cash and checks which were in the cash register. The checks reflect payments made to Apex for goods sold. Drummond disposed of the checks and has disappeared. Apex is worried about its ability to recover the checks from those now in possession of them. Which of the following is correct?

a. Apex will prevail as long as its signature was necessary to negotiate the checks in question.
b. Since there was no valid transfer by Apex to Drummond, subsequent parties have no better rights than the thief had.
c. Apex will prevail only if the checks were payable to cash.
d. Apex will not prevail on any of the checks since it was the only party that could have prevented the theft.

**M82#36.** Industrial Factors, Inc., discounted a $4,000 promissory note, payable in two years, for $3,000. It paid $1,000 initially and promised to pay the balance ($2,000) within 30 days. Industrial paid the balance within the 30 days, but before doing so learned that the note had been obtained originally by fraudulent misrepresentation in connection with the sale of land which induced the maker to issue the note. For what amount will Industrial qualify as a holder in due course?

a. None because the 25% discount is presumptive or prima facie evidence that Industrial is not a holder in due course.
b. $1,000.
c. $3,000.
d. $4,000.

**M82#37.** Although the scope of the Uniform Commercial Code is broad insofar as inclusion of instruments within the definition of commercial paper, it excludes certain instruments from its coverage. Which of the following is not commercial paper?

a. A promissory note payable 30 days after presentation for payment.
b. A draft which is an order to pay.
c. A negotiable certificate of deposit issued by a bank.
d. An investment security which is payable to bearer.

**M82#38.** Cindy Lake is a holder in due course of a negotiable promissory note for $1,000. Which of the following defenses of the maker may be validly asserted against her?

a. A total failure of consideration on the part of the party to whom it was issued.
b. A wrongful filling in of the amount on the instrument by the party to whom it was issued.
c. Nonperformance of a condition precedent to its transfer by the party to whom it was issued.
d. Infancy of the maker to the extent that it is a defense to a simple contract.

**M82#39.** Franklin sold her grain business to Hobson for $150,000 and received a check drawn on Farmer's Bank for that amount. In addition, she entered into a contract for the purchase of a ranch for the same amount. The closing on the ranch is to take place in five days. The sales contract regarding the ranch requires payment by cash, by buyer's certified check, or by certified check payable to the buyer's order and indorsed to the seller. Franklin intends to have Hobson's check certified by Farmer's Bank and use it as payment. Which of the following is correct?

a. If the bank refuses to certify the check, it has been dishonored.
b. If Hobson's account has sufficient funds to honor the check, Franklin has the right to have it certified.
c. Certification by the bank will discharge Hobson from liability as the drawer.
d. Only Hobson can obtain certification of the check.
Selected Questions

M82#40. Hoover is a holder in due course of a check which was originally payable to the order of Nelson or bearer and has the following indorsements on its back:

<table>
<thead>
<tr>
<th>Nelson</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pay to the order of Maxwell</td>
</tr>
<tr>
<td>Duffy</td>
</tr>
<tr>
<td>Without Recourse</td>
</tr>
<tr>
<td>Maxwell</td>
</tr>
<tr>
<td>Howard</td>
</tr>
</tbody>
</table>

Which of the following statements about the check is correct?

a. It was originally order paper.
b. It was order paper in Howard's hands.
c. Maxwell's signature was not necessary for it to be negotiable.
d. Presentment for payment must be made within seven days after indorsement to hold an indorser liable.

M82#41. Your client, Ensign Factors Corporation, has purchased the trade acceptance shown below from Mason Art Productions, Inc. It has been properly indorsed in blank on the back by Mason.

October 15, 1981
Adams Wholesalers, Inc.
49 Buena Vista Avenue
Santa Monica, California

Pay to the order of Mason Art Productions, Inc., ten thousand and 00/100 dollars ($10,000.00).

Gilda Loucks, President
Mason Art Productions, Inc.

Accepted October 24, 1981
Adams Wholesalers, Inc.

By Charles Loucks, President

As to the rights of Ensign, which of the following is correct?

a. The instrument is nonnegotiable, hence Ensign is an assignee.
b. Until acceptance, Mason had primary liability on the instrument.
c. After acceptance by Adams Wholesalers, Adams is primarily liable, and Mason is secondarily liable.
d. After acceptance by Adams, Mason is primarily liable, and Adams is secondarily liable.

M82#42. Balquist sold a negotiable instrument payable to her order to Farley. In transferring the instrument to Farley, she forgot to indorse it. Accordingly

a. Farley qualifies as a holder in due course.
b. Farley has a specifically enforceable right to obtain Balquist's unqualified indorsement.
c. Farley obtains a better right to payment of the instrument than Balquist had.
d. Once the signature of Balquist is obtained, Farley's rights as a holder in due course relate back to the time of transfer.

M82#43. Which of the following provisions contained in an otherwise negotiable instrument will cause it to be nonnegotiable?

a. It is payable in Mexican pesos.
b. It contains an unrestricted acceleration clause.
c. It grants to the holder an option to purchase land.
d. It is limited to payment out of the entire assets of a partnership.

N81
Items 35 and 36 are based on the following information:

Howard Corporation has the following instrument which it purchased in good faith and for value from Luft Manufacturing, Inc.

July 2, 1981
McHugh Wholesalers, Inc.
Pullman, Washington

Pay to the order of Luft Manufacturing, Inc., one thousand seven hundred dollars ($1,700) three months after acceptance.

Peter Crandall, President
Luft Manufacturing, Inc.

Accepted July 2, 1981
McHugh Wholesalers, Inc.

By Charles Teem, President

Crandall indorsed the instrument on the back in his capacity as president of Luft when it was transferred to Howard on July 15, 1981.
35. This instrument
   a. Would be treated as a promissory note since
      the drawee is not a bank.
   b. Is a negotiable draft and Howard is a holder
      in due course.
   c. Is not negotiable under Article 3 (commercial
      paper) of the Uniform Commercial Code, al-
      though it may be negotiable under another
      Article.
   d. Is not negotiable since the drawer and the
      payee are the same person.

36. What liability do McHugh and Luft have to Howard?
   a. McHugh has primary liability and Luft has
      secondary liability.
   b. Luft has primary liability and McHugh has no
      liability.
   c. Luft has primary liability and McHugh has secondary liability.
   d. McHugh has primary liability and Luft has no
      liability.

N81#38. Clarkson received a check from Shipley which was incomplete as to the amount. The check was
given as payment in advance on the purchase of 100 CB radios. The amount was left blank because Clarkson
had the right to substitute other CB models if available for those ordered, which would change the price. It was
agreed that in no event would the purchase price exceed $1,800. Desperate for cash, Clarkson wrongfully sub-
stituted much more expensive CB radios thereby in-
creasing the purchase price to $2,200. Clarkson then
negotiated the check to Marshall, one of his suppliers.
Clarkson filled in the $2,200 in Marshall's presence
showing him the shipping order and invoice applicable
to the sale to Shipley. Marshall accepted the check in
payment of $1,400 overdue debts and $800 in cash.
Under the circumstances, Marshall is
   a. A holder in due course but only to the extent
      of the $800 in cash.
   b. A holder in due course and entitled to recover
      the full amount.
   c. Not a holder in due course because the
      amount filled in was greater than authorized.
   d. Not a holder in due course because the in-
      strument was completed in his presence.

N81#40. A client has in its possession the instrument
below.

I, Margaret Dunlop, hereby promise to pay to
the order of Caldwell Motors five thousand dol-
ars ($5,000) upon the receipt of the final distri-
bution from the estate of my deceased uncle,
Carlton Dunlop. This negotiable instrument is
given by me as the down payment on my purchase
of a 1981 Lincoln Continental to be delivered in
two weeks.

                    [Signature]
                    Margaret Dunlop

The instrument is
   a. Negotiable.
   b. Not negotiable as it is undated.
   c. Not negotiable in that it is subject to the two-
week delivery term regarding the purchase of the
Lincoln Continental.
   d. Not negotiable because it is not payable at a
definite time.

N81#41. Dunbar is the holder and payee of a check.
He takes it to the Federal Bank upon which it was
drawn and has it certified. Which of the following is
correct?
   a. Prior to certification of the check, Federal is
      only secondarily liable on the check.
   b. Federal is obligated to certify the check so
      long as there are adequate funds in the ac-
      count.
   c. After certification of the check, Federal is pri-
      marily liable, and the drawer is discharged on
      the check.
   d. If Federal refuses to certify the check, the
      check will be dishonored.
N81#42. Dilworth, an employee of Excelsior Super Markets, Inc., stole his payroll check from the cashier before it was completed. The check was properly made out to his order but the amount payable had not been filled in because Dilworth’s final time sheet had not yet been received. Dilworth filled in an amount which was $300 in excess of his proper pay and cashed it at the Good Luck Tavern. Good Luck took the check in good faith and without suspecting that the instrument had been improperly completed. Excelsior’s bank paid the instrument in due course. Excelsior is demanding that the bank credit its account for the $300 or that it be paid by Good Luck. Which of the following is correct?
   a. Good Luck has no liability for the return of the $300.
   b. Excelsior’s bank must credit Excelsior’s account for the $300.
   c. A theft defense would be good against all parties including Good Luck.
   d. Only in the event that negligence on Excelsior’s part can be shown will Excelsior bear the loss.

N81#43. Wilbur executed and delivered a check for $80 payable to the order of Muldowney. Muldowney raised the amount to $800, and negotiated it to Lester, who took the check in good faith and for value without notice of the alteration. When Lester presented it for payment to the bank, the bank refused to honor it due to insufficient funds in Wilbur’s account. Lester is seeking to collect the $800 from Wilbur. Which of the following is correct?
   a. Lester is a holder in due course, but is only entitled to collect $80 from Wilbur unless Wilbur’s negligence facilitated the alteration.
   b. The bank’s dishonor of the instrument was wrongful.
   c. Wilbur is liable for $800 since Lester is a holder in due course and the defense is a personal defense.
   d. The material alteration of the check by Muldowney released Wilbur from all liability to subsequent parties.

B. Documents of Title and Investment Securities

M85#40. Unless otherwise agreed, which of the following warranties will not be conferred by a person negotiating a negotiable warehouse receipt for value to his immediate purchaser?
   a. The document is genuine.
   b. The transferor is without knowledge of any fact which would impair its validity or worth.
   c. The goods represented by the warehouse receipt are of merchantable quality.
   d. Negotiation by the transferor is rightful and fully effective with respect to the title to the document.

M84#46. Woody Pyle, a public warehouseman, issued Merlin a negotiable warehouse receipt for fungible goods stored. Pyle
   a. May not limit the amount of his liability for his own negligence.
   b. Will be absolutely liable for any damages in the absence of a statute or a provision on the warehouse receipt to the contrary.
   c. May commingle Merlin’s goods with similar fungible goods of other bailors.
   d. Is obligated to deliver the goods to Merlin despite Merlin’s improper refusal to pay the storage charges due.

N83#46. Hack Company owned 100 tires which it deposited in a public warehouse on April 25, receiving a negotiable warehouse receipt in its name. Hack sold the tires to Fast Freight Co. On which of the following dates did the risk of loss transfer from Hack to Fast?
   a. May 1 — Fast signed a contract to buy the tires from Hack for $15,000. Delivery was to be at the warehouse.
   b. May 2 — Fast paid for the tires.
   c. May 3 — Hack negotiated the warehouse receipt to Fast.
   d. May 4 — Fast received delivery of the tires at the warehouse.

N83#47. Thieves broke into the warehouse of Monogram Airways and stole a shipment of computer parts belonging to Valley Instruments. Valley had in its possession a negotiable bill of lading covering the shipment. The thieves transported the stolen parts to another state and placed the parts in a bonded warehouse. The thieves received a negotiable warehouse receipt which they used to secure a loan of $20,000 from Reliable Finance. These facts were revealed upon apprehension of the thieves. Regarding the rights of the parties
   a. Reliable is entitled to a $20,000 payment before relinquishment of the parts.
   b. Monogram will be the ultimate loser of the $20,000.
   c. Valley is entitled to recover the parts free of Reliable’s $20,000 claim.
   d. Valley is not entitled to the parts but may obtain damages from Monogram.

N83#48. In order to qualify as an investment security under the Uniform Commercial Code, an instrument must be
   a. Issued in registered form, and not bearer form.
   b. Of a long-term nature not intended to be disposed of within one year.
   c. Only an equity security or debenture security, and not a secured obligation.
   d. In a form that evidences a share, participation or other interest in property or in an enterprise, or evidences an obligation of the issuer.
M83#43. The Uniform Commercial Code deals differently with negotiable documents of title than with commercial paper. Which of the following will prevent a due negotiation of a negotiable document of title?
   a. The transfer by delivery alone of a title document which has been endorsed in blank.
   b. The receipt of the instrument in payment of an antecedent money obligation.
   c. The taking of a bearer document of title from one who lacks title thereto.
   d. The fact that the document of title is more than one month old.

M83#44. Under the Uniform Commercial Code's rule, a warehouseman
   a. Is liable as an insurer.
   b. Will not be liable for the nonreceipt or misdescription of the goods stored even to a good faith purchaser for value of a warehouse receipt.
   c. Can not limit its liability in respect to loss or damage to goods while in its possession.
   d. Is liable for damages which could have been avoided through the exercise of due care.

M83#45. A negotiable bill of lading
   a. Is one type of commercial paper as defined by the Uniform Commercial Code.
   b. Can give certain good faith purchasers greater rights to the bill of lading or the goods than the transferor had.
   c. Can not result in a loss to the owner if lost or stolen, provided prompt notice is given to the carrier in possession of the goods.
   d. Does not give the rightful possessors the ownership of the goods.

M83#46. Dwight Corporation purchased the following instrument in good faith from John Q. Billings:

   No.  7200  ••• REGISTERED ••• $10,000
   Magnum Cum Laude Corporation

Ten year 14% Debenture, Due May 15, 1990
Magnum Cum Laude Corporation, a Delaware Corporation, for value received, hereby promises to pay the sum of TEN THOUSAND DOLLARS ($10,000) to JOHN Q. BILLINGS, or registered assigns, at the principal office or agency of the Corporation in Wilmington, Delaware.

On the reverse side of the instrument, the following appeared:

"For value received, the undersigned sells, assigns, and transfers unto DWIGHT CORPORATION, (signed) JOHN Q. BILLINGS." Billings's signature was guaranteed by Capital Trust Company.

Magnum's 14% debentures are listed on the Pacific Coast Exchange. The instrument is

M82#46. A negotiable bill of lading is duly negotiated even though
   a. The negotiation is not in the ordinary course of business.
   b. It is received by the transferee in payment of a money obligation.
   c. It is not negotiable upon issuance, but is subsequently indorsed in blank and transferred.
   d. It is initially payable to the order of a named person, who signs in blank and delivers it to the transferee.

M82#44. While auditing the common stock ledger of Sims Corporation a CPA uncovers the following situation. An investor has purchased a certificate representing 500 shares of common stock of the corporation. It was the duty of the clerk to prepare stock certificates from a supply of blanks for signature of the corporate secretary. The clerk forged the corporate secretary's signature on a bearer certificate and delivered the certificate for value to the investor who did not have notice of the forgery and who now demands a reissued certificate in the investor's name from the corporation. The corporation asserts that it has no liability to reissue a certificate in the name of the investor and that the investor's bearer certificate is null and void. Which of the following is correct?
   a. The certificate is valid and the investor is entitled to a reissued certificate.
   b. The certificate issued is invalid and the corporation has no liability to reissue.
   c. An appropriate recourse of the investor is to sue the corporation and clerk for dollar damages and to sue the clerk for the crime of forgery.
   d. The corporation is required to reissue a certificate only if appropriately compensated by the investor.

M82#45. Wilberforce & Company has in its possession certain securities which it took in good faith and for value from Dunlop. An adverse claim or defense has been asserted against the securities. Which of the following warranties may Wilberforce validly assert against Dunlop, its prior transferor?
   a. There is no defect in the prior chain of title.
   b. The securities are genuine and have not been materially altered.
c. There is no defect which might impair the validity of the securities.

d. Dunlop will defend the purchasers' title from adverse claim or defects which would impair the validity of the securities.

N81#47. Boyd Corporation owned 100 cases of canned fish and stored them in a public warehouse. It asked for and received from the bailee a negotiable warehouse receipt payable to bearer. It sold the document in the ordinary course of business for cash to the Payton Corporation. Boyd delivered the document and indorsed it "Deliver to order of Payton Corporation, signed Boyd Corporation." A thief then stole the document and forged the signature of the Payton Corporation. The thief sold and delivered the document to Slate Corporation who bought it for cash in good faith and in the ordinary course of business. Which of the following is correct?

a. Slate has legal title to the document.
b. Payton has legal title to the document.
c. Boyd has legal title to the document.
d. Payton can recover the document from Slate but must reimburse Slate for the resultant damages.

C. Sales

M85#42. The Uniform Commercial Code's position on privity of warranty as to personal injuries

a. Allows the buyer's family the right to sue only the party from whom the buyer purchased the product.
b. Resulted in a single uniform rule being adopted throughout most of the United States.
c. Prohibits the exclusion on privity grounds of third parties from the warranty protection it has granted.
d. Applies exclusively to manufacturers.

M85#43. Flax telephoned Sky Corp. and ordered a specially manufactured air conditioner for $1,900. Subsequently, Flax realized that he miscalculated the area which was to be cooled and concluded that the air conditioner would not be acceptable. Sky had already completed work on the air conditioner, demanded payment, and was unable to resell the unit at a reasonable price. If Flax refuses to pay and Sky brings an action seeking as damages the price plus reasonable storage charges of $50, Sky will recover

a. Nothing, because of the statute of frauds.
b. Only its lost profit.
c. The full $1,950.
d. Only $1,900.

N84#53. Bizzy Corp. wrote Wang ordering 100 Wang radios for $2500. Wang unequivocably accepted Bizzy's offer but in doing so Wang added a clause providing for interest on any overdue invoices pertaining to the sale, a practice which is common in the industry. If Wang and Bizzy are both merchants and there are no further communications between the parties, relating to the terms, then

a. Wang has made a counteroffer.
b. A contract can not be formed unless Bizzy expressly accepts the term added by Wang.
c. A contract is formed incorporating only the terms of Bizzy's offer.
d. A contract is formed with Wang's additional term becoming a part of the agreement.

N84#54. Wally, a CPA and a neighbor of Rita's, offered to sell Rita his power chain saw for $400. Rita stated that she knew nothing about chain saws but would buy the saw if it were capable of cutting down the trees in her backyard, which had an average diameter of five feet. Wally assured Rita that the saw "would do the job." Relying on Wally's assurance, Rita purchased the saw. Wally has created a warranty that

a. The saw is of an average fair quality.
b. The saw is fit for the ordinary purposes for which it is used.
c. The saw is capable of cutting the trees in Rita's backyard.
d. Is unenforceable because it is not in writing.

N84#55. Where an oral agreement pertaining to goods is entered into without any consideration, the agreement will be binding if it

a. Relates to a requirements contract.
b. Is a firm offer made by a merchant promising to hold the offer open for two months.
c. Modifies the price on an existing sales contract from $600 to $450.
d. Disclaims the implied warranty of fitness for a particular purpose.

N84#56. Mix Clothing shipped 300 custom suits to Tara Retailers. The suits arrived on Thursday, earlier than Tara had anticipated and on an exceptionally busy day for its receiving department. They were perfunctorily examined and sent to a nearby warehouse for storage until needed. On the following day, upon closer examination, it was discovered that the quality of the linings of the suits was inferior to that specified in the sales contract. Which of the following is correct insofar as Tara's rights are concerned?

a. Tara must retain the suits since it accepted them and had an opportunity to inspect them upon delivery.
b. Tara had no rights if the linings were of merchantable quality.
c. Tara can reject the suits upon subsequent discovery of the defects.
d. Tara's only course of action is rescission.

M84#47. Reed purchased 50 dozen pen sets from Wok Corp. Reed made substantial prepayments of the purchase price. Wok is insolvent and the goods have not
been delivered as promised. Reed wants the pens. Under the circumstances, which of the following will prevent Reed from obtaining the pens?

a. The fact that the goods have not been identified to his contract.
b. The fact that he was not aware of Wok's insolvency at the time he purchased the pens.
c. The fact that he can obtain a judgment for damages.
d. The fact that he did not pay the full price at the time of the purchase even though he has made a tender of the balance and holds it available to Wok upon delivery.

M84#48. Nat purchased a typewriter from Rob. Rob is not in the business of selling typewriters. Rob tendered delivery of the typewriter after receiving payment in full from Nat. Nat informed Rob that he was unable to take possession of the typewriter at that time, but would return later that day. Before Nat returned, the typewriter was destroyed by a fire. The risk of loss

a. Passed to Nat upon Rob's tender of delivery.
b. Remained with Rob, since Nat had not yet received the typewriter.
c. Passed to Nat at the time the contract was formed and payment was made.
d. Remained with Rob, since title had not yet passed to Nat.

M84#49. Bell by telegram to Major Corp. ordered 10,000 yards of fabric, first quality, 50% wool and 50% cotton. The shipping terms were f.o.b. Bell's factory in Akron, Ohio. Major accepted the order and packed the fabric for shipment. In the process it discovered that one half of the fabric packed had been commingled with fabric which was 30% wool and 70% cotton. Since Major did not have any additional 50% wool fabric, it decided to send the shipment to Bell as an accommodation. The goods were shipped and later the same day Major wired Bell its apology informing Bell of the facts and indicating that the 5,000 yards of 30% wool would be priced at $2 a yard less. The carrier delivering the goods was destroyed on the way to Akron. Under the circumstances, who bears the risk of loss?

a. Bell, since Bell has title to the goods.
b. Major, because the order was not a signed writing.
c. Bell, since the shipping terms were f.o.b. Bell's place of business.
d. Major, since they shipped goods which failed to conform to the contract.

M84#50. Which of the following statements is correct with regard to an auction of goods?

a. The auctioneer may withdraw the goods at any time prior to completion of the sale unless the goods are put up without reserve.
b. A bidder may retract his bid before the completion of the sale only if the auction is without reserve.
c. A bidder's retraction of his bid will revive the prior bid if the sale is with reserve.
d. In a sale with reserve, a bid made while the hammer is falling automatically reopening the bidding.

M84#51. Sand Corp. received an order for $11,000 of assorted pottery from Gluco, Inc. The shipping terms were f.o.b. Lime Ship Lines, seller's place of business, 2/10, net/30. Sand packed and crated the pottery for shipment and it was loaded upon Lime's ship. While the goods were in transit to Gluco, Sand learned that Gluco was insolvent in the equity sense (unable to pay its debts in the ordinary course of business). Sand promptly wired Lime's office in Galveston, Texas, and instructed them to stop shipment of the goods to Gluco and to store them until further instructions. Lime complied with these instructions. Regarding the rights, duties, and liabilities of the parties, which of the following is correct?

a. Gluco is entitled to the pottery if it pays cash.
b. Sand's stoppage in transit was improper if Gluco's assets exceeded its liabilities.
c. The fact that Gluco became insolvent in no way affects the rights, duties, and obligations of the parties.
d. Once Sand correctly learned of Gluco's insolvency, it had no further duty or obligation to Gluco.

M84#52. Under the UCC, the warranty of title for the sale of goods

a. May not be excluded by the seller.
b. May be excluded by the phrase "as is."
c. Will vest title absolutely in a bona fide purchaser for value provided that the seller is a merchant.
d. Will apply regardless of whether it is provided in the contract unless it is specifically excluded.

M84#53. Olsen purchased a used van from Super Sales Co. for $350. A clause in the written contract in boldface type provided that the van was being sold "as is." Another clause provided that the contract was intended as the final expression of the parties' agreement. After driving the van for one week, Olsen realized that the engine was burning oil. Olsen telephoned Super and requested a refund. Super refused but orally gave Olsen a warranty on the engine for six months. Three weeks later the engine exploded. Super's oral warranty

a. Is invalid since the modification of the existing contract required additional consideration.
b. Is invalid due to the Statute of Frauds.
c. Is valid and enforceable.
d. Although valid, proof of its existence will be inadmissible because it contradicts the final written agreement of the parties.
Selected Questions

M84#55. The UCC Sales Article applies
   a. Exclusively to the sale of goods between merchants.
   b. To the sale of real estate between merchants.
   c. To the sale of specially manufactured goods.
   d. To the sale of investment securities.

M84#56. Which of the following factors will be most important in determining if an express warranty has been created?
   a. Whether the promises made by the seller became part of the basis of the bargain.
   b. Whether the seller intended to create a warranty.
   c. Whether the statements made by the seller were in writing.
   d. Whether the sale was made by a merchant in the regular course of business.

N83#50. Which of the following requirements must be met for modification of a sales contract under the Uniform Commercial Code?
   a. The modification must satisfy the Statue of Frauds if the contract as modified is within its provisions.
   b. There must be consideration present if the contract is between merchants.
   c. The parol evidence rule applies and thus a writing is required.
   d. There must be a writing if the original sales contract is in writing.

N83#51. In order to have an irrevocable offer under the Uniform Commercial Code, the offer must
   a. Be made by a merchant to a merchant.
   b. Be contained in a signed writing which gives assurance that the offer will be held open.
   c. State the period of time for which it is irrevocable.
   d. Not be contained in a form supplied by the offeror.

N83#52. Gold sold Sable ten fur coats. The contract contained no specific provision regarding title warranties. It did, however, contain a provision which indicated that the coats were sold “with all faults and defects.” Two of the coats sold to Sable had been stolen and were reclaimed by the rightful owner. Which of the following is a correct statement?
   a. The implied warranty of title is eliminated by the parol evidence rule.
   b. The contract automatically contains a warranty that the title conveyed is good and can only be excluded by specific language.
   c. Since there was no express title warranty, Sable assumed the risk.
   d. The disclaimer “with all faults and defects” effectively negates any and all warranties.

N83#53. On October 1, Baker, a wholesaler, sent Clark, a retailer, a written signed offer to sell 200 pinking shears at $9 each. The terms were f.o.b. Baker’s warehouse, net 30, late payment subject to a 15% per annum interest charge. The offer indicated that it must be accepted no later than October 10, that acceptance would be effective upon receipt, and that the terms were not to be varied by the offeree. Clark phoned Baker on October 6, and accepted the offer expressly subject to a change of the payment terms to 2/10, net/30. Baker did not accept Clark’s oral acceptance of the original offer. Which of the following is a correct statement?
   a. Baker’s original offer is a firm offer, hence irrevocable.
   b. There is no contract since Clark’s modifications effectively rejected the October 1 offer, and Baker never accepted either of Clark’s proposals.
   c. Clark actually created a contract on October 6, since the modifications were merely proposals and did not preclude acceptance.
   d. The Statute of Frauds would preclude the formation of a contract in any event.

N83#54. The Uniform Commercial Code implies a warranty of merchantability to protect buyers of goods. To be subject to this warranty the goods need not be
   a. Fit for all of the purposes for which the buyer intends to use the goods.
   b. Adequately packaged and labeled.
   c. Sold by a merchant.
   d. In conformity with any promises or affirmations of fact made on the container or label.

N83#55. Donaldson suffered an injury due to a malfunction of a power tool he had purchased from Malloy Hardware. The tool was manufactured by Superior Tool Company. Donaldson has commenced an action against Malloy and Superior based upon strict liability. Which of the following is a correct statement?
   a. Donaldson’s suit against Malloy will be dismissed since Malloy was not at fault.
   b. Privity will not be a valid defense against Donaldson’s suit.
   c. Superior will not be liable if it manufactured the tool in a nonnegligent manner.
   d. The lawsuit will be dismissed since strict liability has not been applied in product liability cases in the majority of jurisdictions.

N83#56. In deciding a controversy involving the question of who has the risk of loss, the court will look primarily to
   a. The intent of the parties manifested in the contract.
   b. The shipping terms used by the parties.
   c. Whether title has passed.
   d. The insurance coverage of the parties.
N83#57. Dey ordered 100 cases of Fancy Brand carrots at list price from Ned Wholesaler. Immediately upon receipt of Dey's order, Ned sent Dey an acceptance which was received by Dey. The acceptance indicated that shipment would be made within seven days. On the seventh day Ned discovered that all of its supply of Fancy Brand carrots had been sold. Instead it shipped 100 cases of Rabbit Brand, stating clearly on the invoice that the shipment was sent only as an accommodation. Which of the following is correct?
   a. Ned's note of accommodation cancels the contract between Ned and Dey.
   b. Dey's order is a unilateral offer, and can only be accepted by Ned's shipment of the goods ordered.
   d. Ned's shipment of Rabbit Brand is a counter-offer, thus no contract exists between Dey and Ned.

N83#58. Marvin contracted to purchase goods from Ling. Subsequently, Marvin breached the contract and Ling is seeking to recover the contract price. Ling can recover the price if
   a. Ling does not seek to recover any damages in addition to the price.
   b. The goods have been destroyed and Ling's insurance coverage is inadequate, regardless of risk of loss.
   c. Ling has identified the goods to the contract and the circumstances indicate that a reasonable effort to resell the goods at a reasonable price would be to no avail.
   d. Marvin anticipatorily repudiated the contract and specific performance is not available.

N83#59. Dodd Company sold Barney & Company 10,000 ball point pens. The shipment, upon inspection, was found to be nonconforming and Barney rejected the pens. Barney purchased the pens elsewhere at a price which was $525 more than the contract price. The Dodd sales contract contained a clause which purported to reduce the statute of limitations provision of the Uniform Commercial Code to one year. Barney has done nothing about the breach except to return the pens and demand payment of the $525 damages. Dodd has totally ignored Barney’s claim. The statute of limitations
   a. Is four years according to the Uniform Commercial Code and can not be reduced by the original agreement.
   b. Will totally bar recovery unless suit is commenced within the time specified in the contract.
   c. May be extended by the parties but not beyond five years.
   d. Can not be reduced by the parties to a period less than two years.

N83#60. Hall is suing the manufacturer, the wholesaler, and the retailer for bodily injuries caused by a lawnmower Hall purchased. Under the theory of strict liability
   a. Privity will be a bar as far as the wholesaler is concerned if the wholesaler did not have a reasonable opportunity to inspect.
   b. Contributory negligence on Hall’s part will always be a bar to recovery.
   c. The manufacturer will avoid liability if it can show it followed the custom of the industry.
   d. Hall may recover despite the fact that he can not show that any negligence was involved.

N83#11. Glass Co. telephoned Hourly Company and ordered 2,000 watches at $2 each. Glass agreed to pay 10% immediately and the balance within ten days after receipt of the entire shipment. Glass forwarded a check for $400 and Hourly shipped 1,000 watches the next day, intending to ship the balance by the end of the week. Glass decided that the contract was a bad bargain and repudiated it, asserting the Statute of Frauds. Hourly sued Glass. Which of the following will allow Hourly to enforce the contract in its entirety despite the Statute of Frauds?
   a. Glass admitted in court that it made the contract in question.
   b. Hourly shipped 1,000 watches.
   c. Glass paid 10% down.
   d. The contract is not within requirements of the Statute.

N83#38. A merchant’s irrevocable written offer (firm offer) to sell goods
   a. Must be separately signed if the offeree supplies a form contract containing the offer.
   b. Is valid for three months unless otherwise provided.
   c. Is nonassignable.
   d. Can not exceed a three-month duration even if consideration is given.

N83#39. In general, disclaimers of implied warranty protection are
   a. Permitted if they are explicit and understandable and the buyer is aware of their existence.
   b. Not binding on remote purchasers with notice thereof.
   c. Void because they are against public policy.
   d. Invalid unless in writing and signed by the buyer.

N83#42. On February 1, 1983, Nugent Manufacturing, Inc., contracted with Costello Wholesalers to supply Costello with 1,000 integrated circuits. Delivery was called for on May 1, 1983. On March 15, 1983, Nugent notified Costello that it would not perform and that Costello should look elsewhere. Nugent had received a larger and more lucrative contract on February 27,
1983, and its capacity was such that it could not fulfill both orders. The facts
a. Are not sufficient to clearly establish an antici-patory repudiation.
b. Will prevent Nugent from retracting its repu-diation of the Costello contract.
c. Will permit Costello to sue immediately after March 15, 1983, even though the performance called for under the contract was not until May 1, 1983.
d. Will permit Costello to sue only after May 1, 1983, the latest performance date.

N82#4. Calvin Poultry Co. offered to sell Chickenshop 20,000 pounds of chicken at 40 cents per pound under specified delivery terms. Chickenshop accepted the offer as follows:

“We accept your offer for 20,000 pounds of chicken at 40 cents per pound per city scale weight certificate.”

Which of the following is correct?
a. A contract was formed on Calvin’s terms.
b. Chickenshop’s reply constitutes a conditional acceptance, but not a counteroffer.
c. Chickenshop’s reply constitutes a counteroffer and no contract was formed.
d. A contract was formed on Chickenshop’s terms.

N82#6. In which of the following situations would an oral agreement without any consideration be binding under the Uniform Commercial Code?
a. A renunciation of a claim or right arising out of an alleged breach.
b. A firm offer by a merchant to sell or buy goods which gives assurance that it will be held open.
c. An agreement which is a requirements contract.
d. An agreement which modifies an existing sales contract.

N82#47. Webster purchased a drill press for $475 from Martinson Hardware, Inc. The press has proved to be defective and Webster wishes to rescind the purchase based upon a breach of implied warranty. Which of the following will preclude Webster’s recovery from Martinson?
a. The press sold to Webster was a demonstration model and sold at a substantial discount; hence, Webster received no implied warranties.
b. Webster examined the press carefully, but as regards the defects, they were hidden defects which a reasonable examination would not have revealed.
c. Martinson informed Webster that they were closing out the model at a loss due to certain deficiencies and that it was sold “with all faults.”
d. The fact that it was the negligence of the manufac-turer which caused the trouble and that the defect could not have been discovered by Martinson without actually taking the press apart.

N82#49. Filmore purchased a Miracle color television set from Allison Appliances, an authorized dealer, for $499. The written contract contained the usual one-year warranty as to parts and labor as long as the set was returned to the manufacturer or one of its authorized dealers. The contract also contained an effective disclaim-er of any express warranty protection, other than that which was included in the contract. It further pro-vided that the contract represented the entire agree-ment and understanding of the parties. Filmore claims that during the bargaining process Surry, Allison’s agent, orally promised to service the set at Filmore’s residence if anything went wrong within the year. Al-lison has offered to repair the set if it is brought to the service department, but denies any liability under the alleged oral express agreement. Which of the following would be the best defense for Allison to rely upon in the event Filmore sues?
a. The Statute of Frauds.
b. The parol evidence rule.
c. The fact that all warranty protection was dis-claimed other than the express warranty con-tained in the contract.
d. The fact that Surry, Allison’s agent, did not have express authority to make such a promise.

M81#14. The Uniform Commercial Code provides for a warranty against infringement. Its primary purpose is to protect the buyer of goods from infringement of the rights of third parties. This warranty
a. Only applies if the sale is between merchants.
b. Must be expressly stated in the contract or the Statute of Frauds will prevent its enforce-ability.
c. Protects the seller if the buyer furnishes spec-i-fications which result in an infringement.
d. Can not be claimed.
D. Secured Transactions

M85

Items 44 and 45 are based on the following information:

On June 3, Muni Finance loaned Page Corp. $20,000 to purchase four computers for use in Page's trucking business. Page contemporaneously executed a promissory note and security agreement. On June 7, Page purchased the computers with the $20,000, obtaining possession that same day. On June 10, Mort, a judgment creditor of Page, levied on the computers.

44. Which of the following statements is correct?
   a. Muni failed to qualify as a purchase money secured lender.
   b. Muni's security interest attached on June 3.
   c. Muni's security interest attached on June 7.
   d. Muni's security interest did not attach.

45. If Muni files a financing statement on June 11, which of the parties will have a priority security interest in the computers?
   a. Mort, since he lacked notice of Muni's security interest.
   b. Mort, since Muni failed to file before Mort levied on the computers.
   c. Muni, since its security interest was perfected within the permissible time limits.
   d. Muni, since its security interest was automatically perfected upon attachment.

M85#48. Perfection of a security interest under the UCC by a creditor provides added protection against other parties in the event the debtor does not pay his debts. Which of the following is not affected by perfection of a security interest?
   a. The trustee in a bankruptcy proceeding.
   b. A buyer in the ordinary course of business.
   c. A subsequent personal injury judgment creditor.
   d. Other prospective creditors of the debtor.

M85

Items 47 and 48 are based on the following information:

Foxx purchased a stereo for personal use from Dix Audio, a retail seller of appliances. Foxx paid 30% of the $600 sales price and agreed to pay the balance in 12 equal principal payments plus interest. Foxx executed a security agreement giving Dix a security interest in the stereo. Dix properly filed a financing statement immediately. After making six payments Foxx defaulted.

47. If Dix takes possession of the stereo, it
   a. Must dispose of the stereo at a public sale.
   b. Must dispose of the stereo within 90 days after taking possession or be liable to the debtor.
Selected Questions

48. If after making the third installment payment, Foxx sold the stereo to Lutz for personal use, who would have a superior interest in the stereo assuming Lutz lacked knowledge of Dix's security interest?
   a. Dix, since it filed a financing statement.
   b. Dix, since more than 30% of the purchase price had been paid.
   c. Lutz, since title passed from Foxx to Lutz.
   d. Lutz, since he purchased without knowledge of Dix's security interest and for personal use.

M85#49. Cole purchased furniture for her home from Thrift Furniture. The contract required Cole to pay 10% cash and the balance in equal installments over 36 months. Cole signed a security agreement with the furniture listed as collateral. Thrift properly filed a financing statement. If Cole makes the final payment due on the contract, Thrift
   a. Must file a termination statement no later than one month after final payment in order to avoid liability unless Cole demands earlier filing.
   b. Must file a termination statement in order to avoid liability only if Cole makes a written demand.
   c. Does not have to file a termination statement since the collateral is consumer goods.
   d. Does not have to file a termination statement since the term of the financing statement is less than five years and will automatically terminate.

M85#50. Minor Corp. manufactures exercise equipment for sale to health clubs and to retailers. Minor also sells directly to consumers in its wholly-owned retail outlets. Minor has created a subsidiary, Minor Finance Corp., for the purpose of financing the purchase of its products by the various customers. In which of the following situations does Minor Finance not have to file a financing statement to perfect its security interest against competing creditors in the equipment sold by Minor?
   a. Sales made to retailers who in turn sell to buyers in the ordinary course of business.
   b. Sales made to any buyer when the equipment becomes a fixture.
   c. Sales made to health clubs.
   d. Sales made to consumers who purchase for their own personal use.

N84#58. Milo Manufacturing Corp. sells baseball equipment to distributors, who in turn sell the equipment to various retailers throughout the U.S. The retailers then sell the equipment to consumers who use the equipment for their own personal use. In all cases, the equipment is sold on credit with a security interest taken in the equipment by each of the respective sellers. Which of the following is correct?
   a. The security interests of all of the sellers remain valid and will take priority even against good faith purchasers for value, despite the fact that resales were contemplated.
   b. The baseball equipment is inventory in the hands of all the parties concerned.
   c. Milo's security interest is automatically perfected since Milo qualifies as a purchase money secured party.
   d. Milo and the distributors must file a financing statement or take possession of the baseball equipment in order to perfect their security interests.

N84#59. Sax purchased from Bosch Tools a new saw for his home workshop for cash. One week later, Sax was called by Cary Finance. Cary explained to Sax that it had been financing Bosch's purchases from the manufacturer and that to protect its interest it had obtained a perfected security interest in Bosch's entire inventory of hardware and power tools, including the saw which Sax bought. Cary further explained that Bosch had defaulted on a payment due to Cary, and Cary intended to assert its security interest in the saw and repossess it unless Sax was willing to make payment of $100 for a release of Cary's security interest. If Sax refuses to make the payment, which of the following statements is correct?
   a. Even if Sax had both actual notice and constructive notice via recordation of Cary's interest, he will prevail if Cary seeks to repossess the saw.
   b. Cary's security interest in the saw is invalid against all parties unless its filing
specifically described and designated the particular saw Sax purchased.

c. Sax must pay the $100 or the saw can be validly repossessed and sold to satisfy the amount Bosch owes Cary and any excess paid to Sax.
d. Sax will not take free of Cary’s security interest if he was aware of said interest at the time he purchased the saw.

M84#60. Unless otherwise agreed, when collateral, covered under the Secured Transactions Article of the UCC, is in the secured party’s possession

a. The risk of accidental loss is on the debtor to the extent of any deficiency in any effective insurance coverage.
b. The secured party will lose his security interest if he commingles fungible collateral.
c. Reasonable expenses incurred to preserve the collateral are chargeable to the secured party.
d. Any repledge of the collateral by the secured party will be unenforceable.

M84#59. Under the UCC, which of the following is correct regarding the disposition of collateral by a secured creditor after the debtor’s default?

a. The collateral must be disposed of at a public sale.
b. It is improper for the secured creditor to purchase the collateral at a public sale.
c. Secured creditors with subordinate claims retain the right to redeem the collateral after the disposition of the collateral to a third party.
d. A good faith purchaser for value and without knowledge of any defects in the sale takes free of any subordinate liens or security interests.

M84#60. Which of the following is necessary in order to have a security interest attach?

a. The debtor must have rights in the collateral.
b. The creditor must take possession of the collateral.
c. There must be a proper filing.
d. The debtor must sign a security agreement which describes the collateral.

M83#47. Attachment and perfection will occur simultaneously when

a. The security agreement so provides.
b. There is a purchase money security interest taken in inventory.
c. Attachment is by possession.
d. The goods are sold on consignment.

M83#49. On November 10, 1982, Cutter, a dealer, purchased 100 lawn mowers. This comprised Cutter’s entire inventory and was financed under an agreement with Town Bank which gave the bank a security interest in all lawn mowers on the premises, all future acquired lawn mowers, and the proceeds of sales. On November 15, 1982, Town Bank filed a financing statement that adequately identified the collateral. On December 20, 1982, Cutter sold one lawn mower to Wills for family use and five lawn mowers to Black for its gardening business. Which of the following is correct?

a. The security interest may not cover after-acquired property even if the parties so agree.
b. The lawnmower sold to Wills would not ordinarily continue to be subject to the security interest.

M84#58. On January 5, Wine purchased and received delivery of new machinery from Toto Corp. for $50,000. The machinery was to be used in Wine’s production process. Wine paid 30% down and executed a security agreement for the balance. On January 9, Wine obtained a $150,000 loan from Safe Bank. Wine signed a security agreement which gave Safe a security interest in Wine’s existing and after-acquired machinery. The security agreement was duly filed by Safe that same day. On January 10, Toto properly filed its security agreement. If Wine defaults on both loans and there are insufficient funds to pay Toto and Safe, which party will have a superior security interest in the machinery purchased from Toto?

a. Safe, since it was the first in time to file and perfect its security interest.
b. Safe, since Toto perfected its security interest by filing after Wine took possession.
c. Toto, since it filed its security agreement within the permissible time limits.
d. Toto, since it acquired a perfected purchase money security interest without filing.
c. The lawnmowers sold to Black would ordinarily continue to be subject to the security interest.

d. The security interest does not include the proceeds from the sale of the lawnmowers to Black.

M83#50. Attachment under Article 9 of the Uniform Commercial Code applies primarily to the rights of
a. Third party creditors.
b. Parties to secured transactions.
c. Holders in due course.
d. Warehousemen.

M83#52. Gilbert borrowed $10,000 from Merchant National Bank and signed a negotiable promissory note which contained an acceleration clause. In addition, securities valued at $11,000 at the time of the loan were pledged as collateral. Gilbert has defaulted on the loan repayments. At the time of default, $9,250, plus interest of $450, was due, and the securities had a value of $8,000. Merchant
a. Must first proceed against the collateral before proceeding against Gilbert personally on the note.
b. Can not invoke the acceleration clause in the note until ten days after the notice of default is given to Gilbert.
c. Must give Gilbert 30 days after default in which to refinance the loan.
d. Is entitled to proceed against Gilbert on either the note or the collateral or both.

N82#52. Lombard, Inc., manufactures exclusive designer apparel. It sells through franchised clothing stores on consignment, retaining a security interest in the goods. Gifford is one of Lombard's franchisees pursuant to a detailed contract signed by both Lombard and Gifford. In order for the security interest to be valid against Gifford with respect to the designer apparel in Gifford's possession, Lombard
a. Must retain title to the goods.
b. Does not have to do anything further.
c. Must file a financing statement.
d. Must perfect its security interest against Gifford's creditors.

N82#54. Two Uniform Commercial Code concepts relating to secured transactions are "attachment" and "perfection." Which of the following is correct in connection with the similarities and differences between these two concepts?
a. They are mutually exclusive and wholly independent of each other.
b. Attachment relates primarily to the rights against the debtor and perfection relates primarily to the rights against third parties.
c. Satisfaction of one automatically satisfies the other.
d. It is not possible to have a simultaneous attachment and perfection.

N82#55. Tawney Manufacturing approached Worldwide Lenders for a loan of $50,000 to purchase vital components it used in its manufacturing process. Worldwide decided to grant the loan but only if Tawney would agree to a field warehousing arrangement. Pursuant to their understanding, Worldwide paid for the purchase of the components, took a negotiable bill of lading for them, and surrendered the bill of lading in exchange for negotiable warehouse receipts issued by the bonded warehouse company that had established a field warehouse in Tawney's storage facility. Worldwide did not file a financing statement. Under the circumstances, Worldwide
a. Has a security interest in the goods which has attached and is perfected.
b. Does not have a security interest which has attached since Tawney has not signed a security agreement.
c. Must file an executed financing statement in order to perfect its security interest.
d. Must not relinquish control over any of the components to Tawney for whatever purpose, unless it is paid in cash for those released.

N82#56. On October 1, 1982, Winslow Corporation obtained a loan commitment of $250,000 from Liberty National Bank. Liberty filed a financing statement on October 2, 1982. On October 5, 1982, the $250,000 loan was consummated and Winslow signed a security agreement granting the bank a security interest in inventory, accounts receivable, and proceeds from the sale of the inventory and collection of the accounts receivable. Liberty's security interest was perfected
a. On October 1.
b. On October 2.
c. On October 5.
d. By attachment.

N82#57. Thrush, a wholesaler of television sets, contracted to sell 100 sets to Kelly, a retailer. Kelly signed a security agreement with the 100 sets as collateral. The security agreement provided that Thrush's security interest extended to the inventory, to any proceeds therefrom, and to the after-acquired inventory of Kelly. Thrush filed his security interest centrally. Later, Kelly sold one of the sets to Haynes who purchased with knowledge of Thrush's perfected security interest. Haynes gave a note for the purchase price and signed a security agreement using the set as collateral. Kelly is now in default. Thrush can
a. Not repossess the set from Haynes, but is entitled to any payments Haynes makes to Kelly on his note.
b. Repossess the set from Haynes as he has a purchase money security interest.
c. Repossess the set as his perfection is first, and first in time is first in right.
d. Repossess the set in Haynes' possession because Haynes knew of Thrush's perfected security interest at the time of purchase.
c. Johnstone’s security interest is perfected against the other creditors of Markum, but not against Harper.
d. Harper would take the drill press free of Johnstone’s security interest even if Johnstone had filed.

M82#49. The Uniform Commercial Code contains numerous provisions relating to the rights and remedies of the parties upon default. With respect to a buyer, these provisions may
a. Not be varied even with the agreement of the buyer.
b. Only be varied if the buyer is apprised of the fact and initials the variances in the agreement.
c. Not be varied insofar as they require the secured party to account for any surplus realized on the disposition of collateral securing the obligation.
d. All be varied by agreement as long as the variances are not manifestly unreasonable.

M82#48. Mansfield Financial lends money on the strength of negotiable warehouse receipts. Its policy is always to obtain a perfected security interest in the receipts against the creditors of the borrowers and to maintain it until the loan has been satisfied. Insofar as this policy is concerned, which of the following is correct?
a. Mansfield may not transfer the warehouse receipts to another lending institution without the debtor’s consent.
b. Relinquishment of the receipts is not permitted under any circumstances without the loss of the perfected security interest in them.
c. Mansfield has a perfected security interest in goods which the receipts represent.
d. If the receipts are somehow wrongfully duly negotiated to a holder, Mansfield’s perfected security interest will not be prejudiced.

M82#50. Dix Laboratories, Ltd., manufactures medical equipment for sale to medical institutions and retailers. Dix also sells directly to consumers in its wholly-owned retail outlets. Dix has created a subsidiary, Dix Finance Corporation, for the purpose of financing the purchase of its products by the various customers. In which of the following situations does Dix Finance have to file a financing statement to perfect its security interest against competing creditors in the equipment sold by Dix?
a. Sales made to consumers who purchase for their own personal use.
b. Sales made to retailers who in turn sell to buyers in the ordinary course of business.
c. Sales made to any buyer when the equipment becomes a fixture.
d. Sales made to medical institutions.

M81#44. Macho Financial loans money on the strength of negotiable warehouse receipts. Its policy is always to obtain a perfected security interest in the receipts and to maintain it until the loan has been satisfied. Insofar as this policy is concerned, which of the following is correct?
a. Macho can not perfect a security interest by filing.
b. Relinquishment of the receipts is not permitted under any circumstances without the loss of the perfected security interest in them.
c. Macho has a perfected security interest in goods which the receipts represent.
d. If the receipts are wrongfully but duly negotiated to a holder, Macho’s perfected security interest will not be prejudiced.
Selected Questions

N81#48. A purchase money security interest
a. May be taken or retained only by the seller of collateral.

b. Is exempt from the Uniform Commercial Code's filing requirements.

c. Entitles the person who is the original purchase money lender to certain additional rights and advantages, which are nontransferable.

d. Entitles the purchase money lender to a priority through a ten-day grace period for filing.

N81#49. Which of the following requirements is not necessary in order to have a security interest attach?

a. The debtor must have rights in the collateral.

b. There must be a proper filing.

c. Value must be given by the creditor.

d. Either the creditor must take possession or the debtor must sign a security agreement which describes the collateral.

N81#50. A filing requirement applies to which of the following transactions under Article 9 (Secured Transactions) of the Uniform Commercial Code?

a. The factoring of accounts receivable.

b. A collateralized bank loan, with securities serving as the collateral.

c. The transfer of an interest in an insurance policy to secure a loan.

d. The retention of title by a seller of land to secure payment under the terms of a land contract.

VII. Property

A. Real and Personal Property

M85#51. Which of the following factors is least significant in determining whether an item of personal property has become a fixture?

a. The value of the item.

b. The manner of attachment.

c. The adaptability of the item to the real estate.

d. The extent of injury which would be caused to the real property by the removal of the item.

M85
Items 52 and 53 are based on the following information:

On July 1, Bean deeded her home to Park. The deed was never recorded. On July 5, Bean deeded the same home to Noll. On July 9, Noll executed a deed, conveying his title to the same home to Baxter. On July 10, Noll and Baxter duly recorded their respective deeds.

52. In order for Noll’s deed from Bean to be effective it must

a. Contain the actual purchase price paid by Noll.

b. Be signed by Noll.

c. Include a satisfactory description of the property.

d. Be recorded with Bean’s seal affixed to the deed.

53. If Noll and Baxter are bona fide purchasers for value, which of the following statements is correct?

a. Baxter’s interest is superior to Park’s.

b. Bean’s deed to Park was void as between Bean and Park because it was not recorded.

c. Bean’s deed to Noll was void because she had no interest to convey.

d. Baxter can recover the purchase price from Noll.

M85#54. In order to create an easement by prescription a person must, in addition to fulfilling other requirements, have

a. Recorded the easement immediately upon its creation.

b. Received the express or implied consent of the true owner.

c. Used the land of another out of necessity.

d. Used the land of another in a manner that is open and notorious.

M83#53. Wilmont owned a tract of waterfront property on Big Lake. During Wilmont’s ownership of the land, several frame bungalows were placed on the land by tenants who rented the land from Wilmont. In addition to paying rent, the tenants paid for the maintenance and insurance of the bungalows, repaired, altered and sold them, without permission or hindrance from Wilmont. The bungalows rested on surface cinderblock and were not bolted to the ground. The buildings could be removed without injury to either the buildings or the land. Wilmont sold the land to Marsh. The deed to Marsh recited that Wilmont sold the land, with buildings thereon, “subject to the rights of tenants, if any, . . .” When the tenants attempted to remove the bungalows, Marsh claimed ownership of them. In de-
deciding who owns the bungalows, which of the following is least significant?

a. The leasehold agreement itself, to the extent it manifested the intent of the parties.
b. The mode and degree of annexation of the buildings to the land.
c. The degree to which removal would cause injury to the buildings or the land.
d. The fact that the deed included a general clause relating to the buildings.

M83#56. Purdy purchased real property from Hart and received a warranty deed with full covenants. Recordation of this deed is

a. Not necessary if the deed provides that recordation is not required.
b. Necessary to vest the purchaser's legal title to the property conveyed.
c. Required primarily for the purpose of providing the local taxing authorities with the information necessary to assess taxes.
d. Irrelevant if the subsequent party claiming superior title had actual notice of the unrecorded deed.

M82#51. A condition in a contract for the purchase of real property which makes the purchaser's obligation dependent upon his obtaining a given dollar amount of conventional mortgage financing

a. Can be satisfied by the seller if the seller offers the buyer a demand loan for the amount.
b. Is a condition subsequent.
c. Is implied as a matter of law.
d. Requires the purchaser to use reasonable efforts to obtain the financing.

M82#52. Park purchased Marshall's department store. At the closing, Park delivered a certified check for the balance due and Marshall gave Park a warranty deed with full covenants to the property. The deed

a. Must be recorded to be valid between the parties.
b. Must recite the actual consideration given by Park.
c. Must be in writing and contain the signature of both parties duly witnessed.
d. Usually represents an exclusive integration of the duties of the seller.

M82#53. Fulcrum Enterprises, Inc., contracted to purchase a four-acre tract of land from Devlin as a site for its proposed factory. The contract of sale is silent on the type of deed to be received by Fulcrum and does not contain any title exceptions. The title search revealed that there are 51 zoning laws which affect Fulcrum's use of the land and that back taxes are due. A survey revealed a stone wall encroaching upon a portion of the land Devlin is purporting to convey. A survey made 23 years ago also had revealed the wall. Regarding the rights and duties of Fulcrum, which of the following is correct?

a. Fulcrum is entitled to a warranty deed with full covenants from Devlin at the closing.
b. The existence of the zoning laws above will permit Fulcrum to avoid the contract.
c. Fulcrum must take the land subject to the back taxes.
d. The wall results in a potential breach of the implied warranty of marketability.

B. Mortgages

M85#55. Lake purchased a home from Walsh for $95,000. Lake obtained a $60,000 loan from Safe Bank to finance the purchase, executing a promissory note and mortgage. The recording of the mortgage by Safe

a. Gives the world actual notice of Safe's interest.
b. Protects Safe's interest against the claims of subsequent bona fide purchasers for value.
c. Is necessary in order that Safe have rights against Lake under the promissory note.
d. Is necessary in order to protect Safe's interest against the claim of a subsequent transferee who does not give value.

M85#56. Gray owned a warehouse free and clear of any encumbrances. Gray borrowed $30,000 from Harp Finance and executed a promissory note secured by a mortgage on the warehouse. The state within which the warehouse was located had a notice-race recording statute applicable to real property. Harp did not record its mortgage. Thereafter, Gray applied for a loan with King Bank, supplying King with certified financial statements which disclosed Harp's mortgage. After review of the financial statements, King approved Gray's loan for $25,000, taking an executed promissory note secured by a mortgage on the warehouse. King promptly recorded its mortgage. Which party's mortgage will be superior?

a. Harp's, since King had notice of Harp's interest.
b. Harp's, since it obtained a purchase money security interest.
c. King's, since it was the first to file.
d. King's, since a title search would fail to reveal Harp's interest.

M85#57. A mortgagor who defaults on his mortgage payments will not be successful if he attempts to

a. Assert the equitable right to redeem.
b. Redeem the property after a judicial foreclosure sale has taken place.
c. Obtain any excess resulting from a judicial foreclosure sale.
d. Contest the validity of the price received at a judicial foreclosure sale by asserting that a higher price could have been received at a later date.
M83#57. Which of the following is an *incorrect* statement regarding a real property mortgage?
   a. It transfers title to the real property to the mortgagee.
   b. It is invariably accompanied by a negotiable promissory note which refers to the mortgage.
   c. It creates an interest in real property and is therefore subject to the Statute of Frauds.
   d. It creates a nonpossessory security interest in the mortgagee.

M83#58. Recordation of a real property mortgage
   a. Is required to validate the rights of the parties to the mortgage.
   b. Will not be effective if improperly filed even if the party claiming superior title had actual notice of its existence.
   c. Perfects the interest of the mortgagee against subsequent bona fide purchasers for value.
   d. Must be filed in the recordation office where the mortgagee’s principal place of business is located.

M83#59. Moch sold her farm to Watkins and took back a purchase money mortgage on the farm. Moch failed to record the mortgage. Moch’s mortgage will be valid against all of the following parties except
   a. The heirs or estate of Watkins.
   b. A subsequent mortgagee who took a second mortgage since he had heard there was a prior mortgage.
   c. A subsequent bona fide purchaser from Watkins.
   d. A friend of Watkins to whom the farm was given as a gift and who took without knowledge of the mortgage.

M83#60. Peters defaulted on a purchase money mortgage held by Fairmont Realty. Fairmont’s attempts to obtain payment have been futile and the mortgage payments are several months in arrears. Consequently, Fairmont decided to resort to its rights against the property. Fairmont foreclosed on the mortgage. Peters has all of the following rights except
   a. To remain in possession as long as his equity in the property exceeds the amount of debt.
   b. An equity of redemption.
   c. To refinance the mortgage with another lender and repay the original mortgage.
   d. A statutory right of redemption.

M82#54. Linderman purchased a tract of land from Noteworthy for $250,000. Noteworthy revealed the fact that there was an existing first mortgage of $100,000 on the property which would be satisfied out of the proceeds of the sale. Effective Title Company’s title search and policy revealed only the first mortgage. Noteworthy did not reveal that there was a $50,000 unrecorded second mortgage on the property held by his father, Vincent. The first mortgage was satisfied at the closing and Linderman presumed he had clear title to the property. A month after the closing, Vincent appeared and claimed that Linderman was obligated to pay the principal and interest on the mortgage he held. Noteworthy has fled the jurisdiction. As among Linderman, Vincent, and Effective, which of the following is correct?
   a. Vincent will prevail since he had a valid second mortgage.
   b. Effective must pay on its title policy since it is an insurer.
   c. Linderman’s failure to obtain an affidavit from Noteworthy representing that there was no other mortgage outstanding will result in his taking subject to the Vincent mortgage.
   d. Linderman will take free of the Vincent mortgage.

M81#53. Golden sold his moving and warehouse business, including all the personal and real property used therein, to Clark Van Lines, Inc. The real property was encumbered by a duly-recorded $300,000 first mortgage upon which Golden was personally liable. Clark acquired the property subject to the mortgage but did not assume the mortgage. Two years later, when the outstanding mortgage was $260,000, Clark decided to abandon the business location because it had become unprofitable and the value of the real property was less than the outstanding mortgage. Clark moved to another location and refused to pay the installments due on the mortgage. What is the legal status of the parties in regard to the mortgage?
   a. Clark took the real property free of the mortgage.
   b. Clark breached its contract with Golden when it abandoned the location and defaulted on the mortgage.
   c. Golden must satisfy the mortgage debt in the event that foreclosure yields an amount less than the unpaid balance.
   d. If Golden pays off the mortgage, he will be able to successfully sue Clark because Golden is subrogated to the mortgagee’s rights against Clark.

M81#54. Tremont Enterprises, Inc., needed some additional working capital to develop a new product line. It decided to obtain intermediate term financing by giving a second mortgage on its plant and warehouse. Which of the following is true with respect to the mortgages?
   a. If Tremont defaults on both mortgages and a bankruptcy proceeding is initiated, the second mortgagee has the status of general creditor.
   b. If the second mortgagee proceeds to foreclose on its mortgage, the first mortgagee must be satisfied completely before the second mortgagee is entitled to repayment.
   c. Default on payment to the second mortgagee will constitute default on the first mortgage.
   d. Tremont can not prepay the second mortgage prior to its maturity without the consent of the first mortgagee.
C. Fire and Casualty Insurance

M85#59. The coinsurance clause with regard to property insurance
   a. Prohibits the insured from obtaining an amount of insurance which would be less than the coinsurance percentage multiplied by the fair market value of the property.
   b. Encourages the insured to be more careful in preventing losses since the insured is always at least partially at risk when a loss occurs.
   c. Permits the insured to receive an amount in excess of the policy amount when there has been a total loss and the insured carried the required coverage under the coinsurance clause.
   d. Will result in the insured sharing in partial losses when the insured has failed to carry the required coverage under the coinsurance clause.

M85#60. The insurable interest requirement with regard to property insurance
   a. May be waived by a writing signed by the insured and insurer.
   b. May be satisfied by a person other than the legal owner of the property.
   c. Must be satisfied at the time the policy is issued.
   d. Must be satisfied by the insured’s legal title to the property at the time of loss.

M83#36. The insurable interest in property
   a. Can be waived by consent of the parties.
   b. Is subject to the incontestability clause.
   c. Must be present at the time the loss occurs.
   d. Is only available to owners, occupiers, or users of the property.

M83#37. The underlying rationale which justifies the use of the coinsurance clause in fire insurance is
   a. It provides an insurable interest in the insured if this is not already present.
   b. To require certain minimum coverage in order to obtain full recovery on losses.
   c. It prevents arson by the owner.
   d. It makes the insured more careful in preventing fires since the insured is partially at risk in the event of loss.

M82#58. The coinsurance feature of property insurance
   a. Is fixed at a minimum of 80% by law.
   b. Prevents the insured from insuring for a minimal amount and recovering in full for such losses.
   c. Precludes the insured from insuring for less than the coinsurance percentage.
   d. Is an additional refinement of the insurable interest requirement.

M82#59. Tedland Trading Corporation insured its 17 automobiles for both liability and collision. Milsap, one of its salesmen, was in an automobile accident while driving a company car on a sales trip. The facts clearly reveal that the accident was solely the fault of Williams, the driver of the other car. Milsap was seriously injured, and the automobile was declared a total loss. The value of the auto was $3,000. Which of the following is an incorrect statement regarding the rights and liabilities of Tedland, its insurer, Milsap and Williams?
   a. Tedland’s insurer must defend Tedland against any claims by Milsap or Williams.
   b. Tedland’s insurer has no liability whatsoever since the accident was the result of Williams’s negligence.
   c. Milsap has an independent action against Williams for the injuries caused by Williams’s negligence.
   d. Tedland’s insurer is liable for $3,000, less any deductible, on the collision policy, but will be subrogated to Tedland’s rights.

M82#60. Which of the following is an incorrect statement regarding the insurable interest requirement as it applies to property insurance?
   a. It is used to determine the amount of recovery to be awarded the insured.
   b. It need not necessarily be present at the inception of the policy so long as it is present at the time of the loss.
   c. One of its functions is to prevent recovery by those who have no economic interest in the property insured.
   d. It can be waived by the parties so long as both are fully competent to contract.

N81#55. Jerry’s House of Jewelry, Inc., took out an insurance policy with the Old Time Insurance Company which covered the stock of jewelry displayed in the store’s windows. Old Time agreed to indemnify Jerry’s House for losses due to window smashing and theft of the jewels displayed. The application contained the following provision: “It is hereby warranted that the maximum value of the jewelry displayed shall not exceed $10,000.” The insurance policy’s coverage was for $8,000. The application was initialed alongside the warranty and attached to the policy. Subsequently, thieves smashed the store window and stole $4,000 worth of jewels. The total value of the display during that week, including the day of the robbery, was $12,000. Which of the following is correct?
   a. Jerry’s House will recover nothing.
   b. Jerry’s House will recover $2,000, the loss less the amount in excess of the $10,000 display limitation.
   c. Jerry’s House will recover the full $4,000 since the warranty will be construed as a mere representation.
   d. Jerry’s House will recover the full $4,000 since attaching the application to the policy is insufficient to make it a part thereof.
Selected Questions

N81#58. Carter, Wallace, and Jones are partners. Title to the partnership’s office building was in Carter’s name. The Carter, Wallace, and Jones partnership procured a $150,000 fire insurance policy on the building from the Amalgamated Insurance Company. The policy contained an 80% coinsurance clause. Subsequently, the building was totally destroyed by fire. The value of the building was $200,000 at the time the policy was issued, and $160,000 at the time of the fire. Under the fire insurance policy, how much can the partnership recover?
   a. Nothing, since it did not have legal title to the building.
   b. The face value of the policy ($150,000).
   c. Eight percent of the loss ($128,000).
   d. The value at the time of the loss ($160,000).

N81#58. Mammoth Furniture, Inc., is in the retail furniture business and has stores located in principal cities in the United States. Its designers created a unique coffee table. After obtaining prices and schedules, Mammoth ordered 2,000 tables to be made to its design and specifications for sale as a part of its annual spring sales promotion campaign. Which of the following represents the earliest time Mammoth will have an insurable interest in the tables?
   a. Upon shipment of conforming goods by the seller.
   b. When the goods are marked or otherwise designated by the seller as the goods to which the contract refers.
   c. At the time the contract is made.
   d. At the time the goods are in Mammoth’s possession.

N81#59. A fire insurance policy is one common type of contract. As such it must meet the general requirements necessary to establish a binding contract. In a dispute between the insured and the insurance company, which of the following is correct?
   a. The contract is always unilateral.
   b. Insurance contracts are specifically included within the general Statute of Frauds.
   c. The insured must satisfy the insurable interest requirement.
   d. The actual delivery of the policy to the insured is a prerequisite to the creation of the insurance contract.

N81#60. Fuller Corporation insured its factory and warehouse against fire with the Safety First Insurance Company. As a part of the bargaining process in connection with obtaining the policy Fuller was required by Safety First to give in writing certain warranties regarding the insured risk. Fuller did so and they were incorporated into the policy. Which of the following correctly describes the law applicable to such warranties?
   a. The warranties given by Fuller will be treated as representations.
   b. It was not necessary that the warranties given by Fuller be in writing to be effective.
   c. In the event that Fuller does not strictly comply with the warranties it has given, it will be denied recovery in a substantial number of states.
   d. In deciding whether the language contained in a policy constitutes a warranty, the courts usually construe ambiguous language in a way which favors the insurance company.

M81#48. Burt owns an office building which is leased to Hansen Corporation under the terms of a long-term lease. Both Burt and Hansen have procured fire insurance covering the building. Which of the following is correct?
   a. Both Burt and Hansen have separate insurable interests.
   b. Burt’s insurable interest is limited to the book value of the property.
   c. Hansen has an insurable interest in the building, but only to the extent of the value of any additions or modifications it has made.
   d. Since Burt has legal title to the building, he is the only party who can insure the building.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. The CPA and the Law

A. Common Law
   Liability to Clients and Third Persons
   N83# 1 c
   N84# 2 b
   N84# 3 d
   N84# 6 a
   N84# 7 d
   N83# 1 a

   B. Federal Statutory Liability
   M81# 1 b
   M81# 6 b
   N83# 5 d
   N83# 6 c
   N83# 7 c
   N83# 8 c
   N83# 10 c
   N81# 2 b

   C. Workpapers, Confidentiality
   N84# 5 b
   N84# 9 c
   N84# 10 a
   N83# 5 d
   N84# 8 b
   N83# 9 d
   N83# 10 c
   M81# 2 d

II. Business Organizations

A. Agency
   N81# 15 a
   N81# 16 d
   M81# 29 c
   M81# 30 a
   M81# 31 d
   M81# 33 c
   M81# 34 b
   N81# 14 a
   N84# 15 d
   M84# 1 a
   M84# 2 a
   M84# 3 a
   M85# 7 b
   M85# 8 d
   N83# 12 b
   N83# 13 b
   N83# 14 a
   N83# 2 d
   N82# 5 c
   N82# 7 a
   N82# 34 c
   N83# 16 a
   N83# 18 b
   N81# 19 d
   N81# 20 d
   N81# 21 b
   N81# 22 d

   B. Partnerships and Joint Ventures
   N83# 11 c
   M85# 6 c
   M85# 7 b
   M85# 8 d
   M85# 10 a
   M85# 9 b

   C. Corporations
   N84# 12 d
   M84# 11 b
   M85# 12 d
   M85# 11 b
   M85# 13 d

   D. Estates and Trusts
   M85# 58 d
   M85# 55 d
   M85# 56 d
   M85# 57 c
   N81# 51 d
   N81# 54 d
   M81# 49 a
   M81# 51 b
III. Contracts

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

A. Suretyship
B. Bankruptcy

V. Government Regulation of Business

A. Regulation of Employment
### B. Federal Securities

- N84#42 b
- N84#44 d
- N84#45 b
- N84#41 a

### VI. Uniform Commercial Code

#### A. Commercial Paper

<table>
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<tr>
<th>Item</th>
<th>Code</th>
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<td>M85#33 a</td>
<td>M82#36 b</td>
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<tr>
<td>M85#34 c</td>
<td>M82#37 d</td>
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<tr>
<td>M85#35 a</td>
<td>M82#38 d</td>
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#### B. Documents of Title and Investment Securities

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### VII. Property

#### A. Real and Personal Property

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#### B. Mortgages

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#### C. Fire and Casualty Insurance

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B-67
ESSAYS — SELECTED QUESTIONS

I. The CPA and the Law

M85
Number 4 (Estimated time — — 15 to 20 minutes)

Arthur & Doyle, CPAs, served as auditors for Dunbar Corp. and Wolfe Corp., publicly held corporations listed on the American Stock Exchange. Dunbar recently acquired Wolfe Corp. pursuant to a statutory merger by issuing its shares in exchange for shares of Wolfe. In connection with that merger, Arthur & Doyle rendered an unqualified opinion on the financial statements and participated in the preparation of the pro forma unaudited financial statements contained in the combined prospectus and proxy statement circulated to obtain shareholder approval of the merger and to register the shares to be issued in connection with the merger. Dunbar prepared a form 8-K (the current report with unaudited financial statements) and form 10-K (the annual report with audited financial statements) in connection with the merger. Shortly thereafter, financial disaster beset the merged company which resulted in large losses to the shareholders and creditors. A class action suit on behalf of the shareholders and creditors has been filed against Dunbar and its management. In addition, it names Arthur & Doyle as co-defendants, challenging the fairness, accuracy, and truthfulness of the financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

As a result of the CPAs having expressed an unqualified opinion on the audited financial statements of Dunbar and Wolfe and as a result of having participated in the preparation of the unaudited financial statements required in connection with the merger, indicate and briefly discuss the various bases of the CPAs’ potential civil liability to the shareholders and creditors of Dunbar under:

a. The federal securities acts.
   b. State common law.

M83
Number 2 (Estimated time — — 15 to 20 minutes)

Part a. The common stock of Wilson, Inc. is owned by 20 stockholders who live in several states. Wilson’s financial statements as of December 31, 1982, were audited by Doe & Co., CPAs, who rendered an unqualified opinion on the financial statements.

In reliance on Wilson’s financial statements, which showed net income for 1982 of $1,500,000, Peters on April 10, 1983, purchased 10,000 shares of Wilson stock for $200,000. The purchase was from a shareholder who lived in another state. Wilson’s financial statements contained material misstatements. Because Doe did not carefully follow GAAS it did not discover that the statements failed to reflect unrecorded expenses which reduced Wilson’s actual net income to $800,000. After disclosure of the corrected financial statements, Peters sold his shares for $100,000, which was the highest price he could obtain.

Peters has brought an action against Doe under federal securities law and state common law.

B-69
**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Will Peters prevail on his federal securities law claims?
2. Will Peters prevail on his state common law claims?

**Part b.** Able Corporation decided to make a public offering of bonds to raise needed capital. On June 30, 1982, it publicly sold $2,500,000 of 12% debentures in accordance with the registration requirements of the Securities Act of 1933.

The financial statements filed with the registration statement contained the unqualified opinion of Baker & Co., CPAs. The statements overstated Able's net income and net worth. Through negligence Baker did not detect the overstatements. As a result, the bonds, which originally sold for $1,000 per bond, have dropped in value to $700.

Ira is an investor who purchased $10,000 of the bonds. He promptly brought an action against Baker under the Securities Act of 1933.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Will Ira prevail on his claim under the Securities Act of 1933?

**M82 Number 2 (Estimated time — 15 to 20 minutes)**

The following information applies to both Parts a and b.

James Danforth, CPA, audited the financial statements of the Blair Corporation for the year ended December 31, 1981. Danforth rendered an unqualified opinion on February 6, 1982. The financial statements were incorporated into Form 10-K and filed with the Securities and Exchange Commission. Blair's financial statements included as an asset a previously sold certificate of deposit (CD) in the amount of $250,000. Blair had purchased the CD on December 29, 1981, and sold it on December 30, 1981, to a third party who paid Blair that day. Blair did not deliver the CD to the buyer until January 8, 1982. Blair deliberately recorded the sale as an increase in cash and other revenue thereby significantly overstating working capital, stockholders' equity, and net income. Danforth confirmed Blair's purchase of the CD with the seller and physically observed the CD on January 5, 1982.

**Part a.** Assume that on January 18, 1982, while auditing other revenue, Danforth discovered that the CD had been sold. Further assume that Danforth agreed that in exchange for an additional audit fee of $20,000, he would render an unqualified opinion on Blair's financial statements (including the previously sold CD).

**Required:** Answer the following, setting forth reasons for any conclusions stated.

2. Assume the SEC discovers and makes immediate public disclosure of Blair's action with the result that no one relies to his detriment upon the audit report and financial statements. Under these circumstances, will the SEC prevail in its criminal action against Danforth?

**Part b.** Assume that Danforth performed his audit in accordance with generally accepted auditing standards (GAAS) and exercised due professional care, but did not discover Blair's sale of the CD. Two weeks after issuing the unqualified opinion, Danforth discovered that the CD had been sold. The day following this discovery, at Blair's request, Danforth delivered a copy of the audit report, along with the financial statements, to a bank which in reliance thereon made a loan to Blair that ultimately proved uncollectible. Danforth did not advise the bank of his discovery.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

If the bank sues Danforth for the losses it sustains in connection with the loan, will it prevail?

**M82 Number 3 (Estimated time — 15 to 20 minutes)**

**Part a.** Ralph Sharp, CPA, has audited the Fargo Corporation for the last ten years. It was recently discovered that Fargo's top management has been engaged in some questionable financial activities since the last audited financial statements were issued.

Subsequently, Fargo was sued in state court by its major competitor, Nuggett, Inc. In addition, the SEC commenced an investigation against Fargo for possible violations of the federal securities laws.

Both Nuggett and the SEC have subpoenaed all of Sharp's workpapers relating to his audits of Fargo for the last ten years. There is no evidence either that Sharp did anything improper or that any questionable financial activities by Fargo occurred prior to this year.

Sharp estimates that the cost for his duplicate photocopying of all of the workpapers would be $25,000 (approximately one year's audit fee). Fargo has instructed Sharp not to turn over the workpapers to anyone.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. If Sharp practices in a state which has a statutory accountant-client privilege, may the state's accountant-client privilege be successfully asserted to avoid turning over the workpapers to the SEC?
2. Assuming Sharp, with Fargo's permission, turns over to Nuggett workpapers for the last two audit...
Selected Questions

years, may the state's accountant-client privilege be successfully asserted to avoid producing the workpapers for the first eight years?

3. Other than asserting an accountant-client privilege, what major defenses might Sharp raise against the SEC and Nugget in order to resist turning over the subpoenaed workpapers?

Part b. Pelham & James, CPAs, were retained by Tom Stone, sole proprietor of Stone Housebuilders, to compile Stone's financial statements. Stone advised Pelham & James that the financial statements would be used in connection with a possible incorporation of the business and sale of stock to friends. Prior to undertaking the engagement, Pelham & James were also advised to pay particular attention to the trade accounts payable. They agreed to use every reasonable means to determine the correct amount.

At the time Pelham & James were engaged, the books and records were in total disarray. Pelham & James proceeded with the engagement applying all applicable procedures for compiling financial statements. They failed however, to detect and disclose in the financial statements Stone's liability for certain unpaid bills. Documentation concerning those bills was available for Pelham & James's inspection had they looked. This omission led to a material understatement (§60,000) of the trade accounts payable.

Pelham & James delivered the compiled financial statements to Tom Stone with their compilation report which indicated that they did not express an opinion or any other assurance regarding the financial statements. Tom Stone met with two prospective investors, Dickerson and Nichols. At the meeting, Pelham & James stated that they were confident that the trade accounts payable balance was accurate to within $8,000.

Stone Housebuilders was incorporated. Dickerson and Nichols, relying on the financial statements, became stockholders along with Tom Stone. Shortly thereafter, the understatement of trade accounts payable was detected. As a result, Dickerson and Nichols discovered that they had paid substantially more for the stock than it was worth at the time of purchase.

Required: Answer the following, setting forth reasons for any conclusions stated.
1. In the event McCoy Forging sues Donovan & Company, will it prevail in whole or in part?
2. Might there be any liability to McCoy Forging on McCoy's part and if so, under what theory?

Part b. Arm Watchband Company manufactures a full line of expansion watch bands, including platinum, gold, and a medium-priced silver. With the skyrocketing prices of precious metal and booming sales, Arm is bursting at the seams with cash and extremely valuable inventory. Dutch, the controller of Arm, noted some irregularities which aroused his suspicion that there might be some embezzlement of company funds. He therefore instituted a full-fledged internal audit of the company's books and records, examined all accounting procedures, and took other appropriate steps necessary to assure himself that nothing was amiss. The only thing unearthed by this was a $300 discrepancy in petty cash which had apparently been stolen.

Dutch talked to Wheeler, the president of Arm, and told him his fears. He also suggested that in addition to the regular annual audit performed by Rice & Campbell, CPAs, that they be engaged to perform a full-fledged defalcation audit. This was authorized by
Wheeler, and the engagement letter for the audit in question clearly reflected this understanding.
Rice & Campbell performed the normal annual audit in their usual competent, nonnegligent manner. The special defalcation audit revealed additional shortages in petty cash. The method was determined and the culprit was exposed and dismissed. Nothing else was revealed despite the fact that the customary procedures for such an audit were followed. Ten months later, Schultz, the warehouse supervisor, was caught by another employee substituting inexpensive copies of the watchbands for the genuine Arm items. The copies were remarkably similar to the originals in appearance. In fact, it would take a precious metals expert to tell
the difference based upon a careful visual examination. The packaging was the same since Schultz had access to the packaging materials, including the seals which were used in an attempt to provide greater security and detect theft. Schultz always placed the boxes of the copies at the bottom of the inventory supplies. Despite this fact one such carton had been shipped to a leading department store several months ago, but the substitution of copies for the originals had not been detected.

Required: Answer the following, setting forth reasons for any conclusions stated.
Would Rice & Campbell be liable for failure to detect the defalcation scheme in question?

II. Business Organizations

B. Partnerships and Joint Ventures

M84
Number 5 (Estimated time — 15 to 20 minutes)

Number 5 consists of two unrelated parts.

Part a. Hart was a partner in the Hart, Gray & Race partnership. He entered into a contract conveying to Paul his partnership interest. The contract, which was consented to by Gray and Race, provided that Paul would become a partner. All known past and present partnership creditors were given written notice of Hart's withdrawal. Within nine months, the partnership became insolvent. The parties are concerned about their liability for the partnership obligations.

Required: Answer the following, setting forth reasons for any conclusions stated.
1. What effect does Hart's withdrawal have upon his liability with respect to existing debts of the partnership and to debts incurred after his withdrawal?
2. Describe Paul's liability for partnership obligations entered into prior to and after his admission to the partnership.

N82
Number 3

Number 3 consists of two unrelated parts.

Part b. While auditing the financial statements of Graham, Phillips, Killian, and Henderson, a real estate partnership, for the year ended December 31, 1981, a CPA uncovers a number of unrelated events which warrant closer analysis:

- Graham died and left her partnership interest to her spouse.
- Phillips owned some real estate prior to the formation of the partnership but never formally transferred legal title to the partnership. The real estate has been used for partnership business since the partnership began its existence, and the partnership has paid all taxes associated with the real estate.
- Killian owes a considerable sum of money to a creditor, Jamison. Jamison has a judgment against Killian and has begun a foreclosure action against certain land owned by the partnership in order to satisfy his claim against Killian.
- Henderson sold some of the partnership real estate for value remitted to the partnership without the approval of the other partners. This sale exceeded Henderson's actual authority but appeared to be a customary sale in the ordinary course of business.

Required: Answer the following, setting forth reasons for any conclusions stated.
1. Graham's spouse is presently seeking to exercise his spousal rights to obtain certain specific property owned by the partnership. Discuss the likely outcome of this matter.
2. Regarding the real estate that is legally in Phillips's name, can the partnership properly reflect this as an asset in the partnership's balance sheet?
3. Will Jamison succeed in his land foreclosure action?
4. If the partnership now wishes to rescind the sale of the real estate by Henderson, can it lawfully do so?

M81
Number 5 (Estimated time — 15 to 20 minutes)

Part a. Davis and Clay are licensed real estate brokers. They entered into a contract with Wilkins, a licensed building contractor, to construct and market residential housing. Under the terms of the contract, Davis and Clay were to secure suitable building sites, furnish prospective purchasers with plans and specifications, pay for appliances and venetian blinds and drapes, obtain purchasers, and assist in arranging for financing. Wilkins was to furnish the labor, material,
and supervision necessary to construct the houses. In accordance with the agreement, Davis and Clay were to be reimbursed for their expenditures. Net profits from the sale of each house were to be divided 80% to Wilkins, 10% to Davis, and 10% to Clay. The parties also agreed that each was to be free to carry on his own business simultaneously and that such action would not be considered a conflict of interest. In addition, the agreement provided that their relationship was as independent contractors, pooling their interests for the limited purposes described above.

Ace Lumber Company sold lumber to Wilkins on credit from mid-1980 until February 1981. Ace did not learn of the agreement between Davis, Clay and Wilkins until April 1981, when an involuntary bankruptcy petition was filed against Wilkins and an order for relief entered. Ace Lumber has demanded payment from Davis and Clay. The lumber was used in the construction of a house pursuant to the agreement between the parties.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In the event Ace sues Davis and Clay as well as Wilkins, will Ace prevail? Discuss the legal basis upon which Ace will rely in asserting liability.

**Part b.** Lawler is a retired film producer. She had a reputation in the film industry for aggressiveness and shrewdness; she was also considered somewhat overbearing. Cyclone Artistic Film Productions, a growing independent producer, obtained the film rights to "Claws," a recent best-seller. Cyclone has decided to syndicate the production of "Claws." Therefore, it created a limited partnership, Claws Productions, with Harper, Von Hinden and Graham, the three ranking executives of Cyclone, serving as general partners. The three general partners each contributed $50,000 to the partnership capital. One hundred limited partnership interests were offered to the public at $50,000 each. Lawler was offered the opportunity to invest in the venture. Intrigued by the book and restless in her retirement, she decided to purchase 10 limited partnership interests for $500,000. She was the largest purchaser of the limited partnership interests of Claws Productions. All went well initially for the venture, but midway through production, some major problems arose. Lawler, having nothing else to do and having invested a considerable amount of money in the venture, began to take an increasingly active interest in the film's production.

She began to appear frequently on the set and made numerous suggestions on handling the various problems that were encountered. When the production still seemed to be proceeding with difficulty, Lawler volunteered her services to the general partners who as a result of her reputation and financial commitment to "Claws" decided to invite her to join them in their executive deliberations. This she did and her personality insured an active participation.

"Claws" turned out to be a box-office disaster and its production costs were considered to be somewhat extraordinary even by Hollywood standards. The limited partnership is bankrupt and the creditors have sued Claws Productions, Harper, Von Hinden, Graham, and Lawler.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What are the legal implications and liabilities of each of the above parties as a result of the above facts?

**C. Corporations**

**M84**

**Number 5 (Estimated time — 15 to 20 minutes)**

Jim Bold is a promoter for a corporation to be formed and known as Wonda Corp. Bold entered into several supply and service agreements with Servco. These agreements were executed in Wonda's name, expressly contingent upon adoption by Wonda, when formed, and were based solely on Wonda's anticipated financial strength. Within two weeks after the signing of the agreements, Wonda was duly formed and operating. Shortly thereafter, Wonda by its board of directors rejected the preincorporation agreements entered into by Bold and Servco, stating that it could obtain more beneficial contracts elsewhere.

During the first year of Wonda's operations certain members of its board of directors were accused of negligence in the performance of their duties. In addition, there were allegations made that these same directors failed to exercise due care by paying cash dividends to shareholders that exceeded the profits and paid in capital. These directors based their decision upon negligently prepared reports issued by the Vice-President of Finance indicating that there were sufficient funds to pay cash dividends to shareholders. These incidents caused Wonda severe liquidity problems and huge losses in the following year of operation. White, a shareholder in Wonda, has properly commenced a suit against these directors.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

a. Discuss Wonda's and Bold's liability to Servco on the preincorporation agreements.

b. What are the necessary requirements to properly declare and pay cash dividends?

c. What defense(s) are available to the directors regarding the charges of negligence in the performance of their duties and the failure to exercise due care in declaring cash dividends?

**M83**

**Number 4 (Estimated time — 15 to 20 minutes)**

Cox is a disgruntled shareholder of Hall, Inc. She has owned 6% of the voting stock for several years. Hall is a corporation with 425 shareholders. However,
the members of the Hall family own 65% of the corporate stock, dominate the board, and are the principal officers of the corporation. There is one minority board member. Recently, there have been major changes in Hall’s board and its officers as the older generation of the family has relinquished the management in favor of the next generation of Halls. It is the action of this new board and management that has caused Cox to contemplate taking drastic action against the current board and officers. Specifically, she objects to the following:

- The board has drastically cut the dividend payments on the common stock. The board’s explanation is that additional funds for expansion or acquisitions are critical for the growth of the corporation. The earnings have been increasing at a rate of 10% per year during this period. Cox claims that the real reason for the dividend cut is to force minority shareholders such as herself to sell. This claim is based on conjecture on her part. Cox is considering an action against the board to compel reinstatement on the prior dividend payout.

- The board also decided to sell 5,000 shares of treasury stock at $10 a share to raise additional capital. The stock in question had originally been sold at $16 a share and had a $12 par value. It was reacquired at $13 per share. Cox first alleges that the corporation is prohibited from acquiring its own shares without specific authorization in the articles of incorporation. The articles of incorporation are silent on this matter. Cox also asserts that the corporation is prohibited from selling the shares at a price less than par.

- Substantial salaries are paid to the officers of the corporation. Salaries of the newcomers have been increased at an annual rate of 10%, which is far in excess of raises voted by the old board. Cox has evidence to show that the corporation’s salary scale has risen from the top 50% to the top 33 1/3% of salaries paid by similar corporations in the industry. Cox asserts that based upon the recipients’ ages, experience and contribution to the corporation, they are so grossly overpaid that the payments constitute a waste of corporate assets. Cox demands that the salary increases be repaid.

- The board has become factionalized because of hostility within the Hall family. Cox claims that this acrimony has generated useless debate and bickering and is counterproductive to the continued success of Hall, Inc. The majority has threatened to oust the opposition at the next election of the board. Cox claims that all of these actions are seriously impairing the effective management of the corporation and she is contemplating seeking a court-ordered dissolution of Hall.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the merits of each of the above claims and indicate the probable outcome of any court action taken by Cox personally or taken by her for and on behalf of the corporation.

**N82 Number 3**

Number 3 consists of two unrelated parts.

**Part a.** William Harrelson is president of the Billings Corporation, a medium-size manufacturer of yogurt. While serving as president, Harrelson learns of an interesting new yogurt product loaded with vitamin additives and with a potentially huge market. He immediately forms another corporation, the Wexler Corporation, to produce and market the new product. In his zeal, however, Harrelson overextends his personal credit and utilizes Billings’s credit, along with its plant and employees, as needed, to produce the new product. The new product becomes a big success. As a result, Harrelson’s Wexler stock is presently worth millions of dollars.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Billings’s shareholders contend that Harrelson’s actions are improper and seek a remedy against him. Will they succeed and what remedies are available to them?

**D. Estates and Trusts**

**N83 Number 5**

Number 5 consists of two unrelated parts.

**Part b.** Mr. & Mrs. Charles Crawford were in the 50% income tax bracket for federal income tax purposes. The Crawfords had two children, June and Virgil, ages 16 and 15. The Crawfords decided that they would like to shift some of their income to the children, but were unwilling to make outright gifts. They consulted with their CPA, banker and attorney and, after considerable discussion, decided to create a short-term irrevocable trust for the benefit of the children with Clearview Trust Company as trustee. The duration of the trust was, as stated in the trust agreement, ten years plus one day from the execution of the trust agreement. The trust agreement was dated August 1, 1982, and the intent of the parties was to convey the Sunnydale property to the trustee after the mortgage on the property had been satisfied. The mortgage was satisfied on November 15, 1982, and the property conveyed in trust to the trustee on December 1, 1982. Net rental income from the Sunnydale property for the period from December 1, 1982 to December 31, 1982, the end of the tax year chosen for the trust, was $14,000. This amount was paid to the children in 1982 and $7,000 of trust income was reported for income tax purposes by each...
of the children. Mr. & Mrs. Crawford excluded the $14,000 from their income tax return.

As a result of a routine audit of the Crawford family returns for 1982, the Internal Revenue Service refused to accept the income as being properly includible in the children’s returns and reallocated it to Mr. & Mrs. Crawford.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

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**III. Contracts**

**N84**  
**Number 3 (Estimated time — — 15 to 20 minutes)**

Beach, a 17-year-old minor, entered into an installment contract to purchase a travel agency from Reid. The purchase price included the fair market value of the tangible assets and an agreed upon value for goodwill. At the time the contract was entered into, Beach misrepresented his age to Reid, claiming that he was 19. The age of majority in their jurisdiction was 18. Since Reid was unsure of Beach’s financial position, Reid requested that Beach obtained a surety. Therefore, Beach entered into an agreement for Abel to act as a surety on the installment contract. Beach knowingly induced Abel to become a surety by supplying Abel with false financial statements.

The contract also provided that Reid was to receive a substantial payment in consideration of his agreement not to operate a travel agency within a one mile radius of Beach’s travel agency for a period of two years. After 19 months, Reid opened a new travel agency across the street from Beach’s business. Within one month thereafter, Beach lost nearly all of his clients to Reid, and Beach defaulted on the installment payments, causing the entire amount owed to Reid to become due. Reid has brought an action against Beach and Abel to recover all monies due him.

Beach claims he is not liable on the contract since:

- He was only 17 years old at the time the contract with Reid was signed.
- The clause prohibiting Reid from competing with him is legally valid and therefore Reid’s violation of such clause constitutes a breach of the sale contract.

Abel claims that he is not liable to Reid since:

- He was induced into becoming a surety by Beach’s fraud.
- Beach was 17 years old at the time the contract with Reid was entered into.
- Reid breached the sale contract by failing to comply with the express clause prohibiting competition with Beach.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Assuming the contract is not divisible, discuss in separate paragraphs the assertions of Beach and Abel, indicating first whether such claims are correct.

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**M84**  
**Number 3 (Estimated time — — 15 to 20 minutes)**

Jones signed an irrevocable 30-day option giving Lark the right to purchase a described tract of land owned by Jones at $20,000 per acre. Lark was a director of King Corporation and knew that King had purchased through a nominee the adjacent land and needed Jones’ land in order to build its national headquarters. Lark did not disclose this information to Jones and hoped to make a profit from the option. Jones had heard that Lark was in personal financial trouble and believed Lark would be unable to raise the money to exercise the option. Furthermore, Jones had no intent to be bound by the option at the time he signed it. The option stated that it was given in exchange for $100 and other good and valid consideration but the $100 was not paid nor was there in fact any other consideration.

Ten days later Jones learned that Lark had granted an option to King to purchase Jones’ land at $30,000 per acre. Lark tendered to Jones full cash payment at $20,000 per acre within the 30-day period. Jones refused to honor the option. Lark brings an action for specific performance of the option.

Jones asserts the following defenses:

- Lark breached his fiduciary duty to the King shareholders by personally entering into the option.
- Lark committed fraud by not disclosing all information regarding the proposed use of the land.
- The option given by Jones does not satisfy the Statute of Frauds.
- Jones never intended to be bound.
- There was no consideration given for his option.
- Specific performance is not a proper remedy.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss the merit of each of Jones’ assertions and then reach an overall conclusion based upon the facts presented.

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**N83**  
**Number 4 (Estimated time — — 15 to 20 minutes)**

Bar Manufacturing and Cole Enterprises were arch
rivals in the high technology industry and both were feverishly working on a new product which would give the first to develop it a significant competitive advantage. Bar engaged Abel Consultants on April 1, 1983, for one year, commencing immediately, at $7,500 a month to aid the company in the development of the new product. The contract was oral and was consummated by a handshake. Cole approached Abel and offered them a $10,000 bonus for signing, $10,000 a month for nine months, and a $40,000 bonus if Cole was the first to successfully market the new product. In this connection, Cole stated that the oral contract Abel made with Bar was unenforceable and that Abel could walk away from it without liability. In addition, Cole made certain misrepresentations regarding the dollar amount of its commitment to the project, the stage of its development, and the expertise of its research staff. Abel accepted the offer.

Four months later, Bar successfully introduced the new product. Cole immediately dismissed Abel and has paid nothing beyond the first four $10,000 payments plus the initial bonus. Three lawsuits ensued: Bar sued Cole, Bar sued Abel, and Abel sued Cole.

Required: Answer the following, setting forth reasons for any conclusions stated.

Discuss the various theories on which each of the three lawsuits is based, the defenses which will be asserted, the measure of possible recovery, and the probable outcome of the litigation.

M82
Number 4 (Estimated time — — 15 to 20 minutes)

Part a. Craig Manufacturing Company needed an additional supply of water for its plant. Consequently, Craig advertised for bids. Shaw Drilling Company submitted the lowest bid and was engaged to drill a well. After a contract had been executed and drilling begun, Shaw discovered that the consistency of the soil was much harder than had been previously encountered in the surrounding countryside. In addition, there was an unexpected layer of bedrock. These facts, unknown to both Craig and Shaw when the contract was signed, significantly increased the cost of performing the contract. Therefore, Shaw announced its intention to abandon performance unless it was assured of recovering its cost. Craig agreed in writing to pay the amount of additional cost if Shaw would continue to drill and complete the contract. Shaw, on the strength of this written promise, completed the job. The additional cost amounted to $10,000 which Shaw now seeks to recover. Craig refuses to pay and asserts that the additional burden was a part of the risk assumed and that the only reason it agreed to pay the additional amount was that it needed the additional water supply on time as agreed.

Shaw has commenced legal action to recover the $10,000 in dispute. Craig denies liability.

Required: Answer the following, setting forth reasons for any conclusions stated.

1. What is the legal liability of Craig as a result of the facts described above?
2. Suppose the contract had been for the purchase of computer parts and the manufacturer had encountered a significant increase in labor cost which it wished to pass on to the purchaser. Would the purchaser’s subsequent written promise to make an additional payment have been binding?

Part b. Ogilvie is a wealthy, prominent citizen of Clarion County. Most of his activities and his properties are located in Vista City, the county seat. Among his holdings are large tracts of farmland located in the outlying parts of Clarion. He has not personally examined large portions of his holdings due to the distance factor and the time it would take. One of his agents told him that 95% of the land was fertile and could be used for general farming. Farber, a recent college graduate who inherited a modest amount of money, decided to invest in farmland and raise avocados. He had read certain advertising literature extolling the virtues of avocado farming as an investment. He called upon Ogilvie and discussed the purchase of his land. In the process, Ogilvie praised his land as a great investment for the future. He stated that the land was virtually all splendid farmland and that it would be suitable for avocado growing. Farber entered into a contract of purchase and made a deposit of 10% on the purchase price.

On the eve of the closing, Farber learned of the presence of extensive rock formations at or near the surface of the land. These rock formations make avocado growing virtually impossible but still permit limited use for some other types of farming. These rock formations are partially visible and could have been seen if Farber had examined the property. They cover approximately 25% of the land.

Accordingly, Farber refused to perform the original contract and demanded that the unsuitable 25% of the land be severed from the contract and the price diminished accordingly.

Ogilvie asserted that “a contract is a contract” and that the doctrine of caveat emptor is applicable in the sale of land. Specifically, he stated that he committed no fraud because:

1. Nothing he said was a statement of fact. It was opinion or puffing.
2. His statements were not material since most of the land is okay, and the balance can be used for some types of farming.
3. He had not lied since he had no knowledge of the falsity of his statements.
4. Farber could have and should have inspected and by failing to do so he was negligent and cannot recover.

Farber then commenced legal proceedings against Ogilvie based on fraud.

Required: Answer the following, setting forth reasons for any conclusions stated.

In separate paragraphs, discuss the validity of each of Ogilvie’s four assertions that he committed no fraud.
Selected Questions

IV. Debtor-Creditor Relationships

A. Suretyship

N83
Number 3

Number 3 consists of two unrelated parts.

Part b. Mars Finance Company was approached by Grant, the president of Hoover Corp., for a loan of $25,000 for Hoover. After careful evaluation of Hoover’s financial condition, Mars decided it would not make the loan unless the loan was collateralized or guaranteed by one or more sureties for a total of $30,000. Hoover agreed to provide collateral in the form of a security interest in Hoover’s equipment. The initial valuation of the equipment was $20,000 and Hoover obtained Victory Surety Company as a surety for the additional $10,000. Prior to the granting of the loan, the final valuation on the equipment was set at $15,000 and Mars insisted on additional surety protection of $5,000. Grant personally assumed this additional surety obligation. Hoover has defaulted and Mars first proceeded against the collateral, which was sold for $17,000. It then proceeded against Victory for the balance. Victory paid the $8,000 and now seeks a $4,000 contribution from Grant.

Grant asserts the following defenses and arguments in order to avoid or limit his liability:

• That he is not liable since Mars elected to proceed against the collateral.
• That Mars, by suing Victory for the deficiency, released him.
• That he is not a surety because Victory did not know of his existence until after default and his surety obligation was not assumed at the same time nor was it equal in amount, hence, there is no right of contribution.
• That in no event is he liable for the full $4,000 sought by Victory.

Required: Answer the following, setting forth reasons for any conclusions stated.

In separate paragraphs, discuss whether the trustee in bankruptcy can properly avoid or set aside the three transfers made by Baker? Was the trustee correct by including in the debtor’s estate rents on the warehouse and the property received as a result of the final divorce decree?

N83
Number 3

Number 3 consists of two unrelated parts.

Part a. Skidmore, doing business as Frock & Fashions, is hopelessly insolvent. Several of his aggressive creditors are threatening to attach his property or force him to make preferential payments of their debts. In fairness to himself and to all his creditors, Skidmore has filed a voluntary petition in bankruptcy on behalf of himself and Frock & Fashions. An order for relief has been entered.

Skidmore’s bankruptcy is fairly straightforward with the following exceptions:

• Skidmore claims exemptions for his summer cottage and for his home.
• Morse, a business creditor, asserts that commercial creditors have a first claim to all Skidmore’s property, business and personal.

On July 1, Sam Baker, a sole proprietor operating a drugstore, was involuntarily petitioned into bankruptcy by his creditors. At that time, and for at least 60 days prior thereto, Baker was unable to pay his current obligations and also had a negative net worth. Prior to the filing of the petition Baker made the following transfers:

• May 17 — Paid Nix, an unsecured creditor, the full $7,500 outstanding on a loan obtained from Nix on April 10.
• June 6 — Gave Mary Wax a mortgage on his home for a loan which Wax made to Baker on June 4 which they intended to be a secured loan.
• June 16 — Paid the electric bill for the month of May which was incurred in Baker’s business. The bill was received by Baker on June 4 and had a June 18 due date.

At the time the petition was filed, Baker owned a rental warehouse and was involved in a divorce proceeding. The trustee in bankruptcy has informed Baker that the debtor’s (Baker’s) estate will include the following nonexempt property:

• Rents received from July 1 through November 1 on the warehouse.
• Property received on October 10 as a result of the Bakers’ final divorce decree.

Required: Answer the following, setting forth reasons for any conclusions stated.

In separate paragraphs, discuss whether the trustee in bankruptcy can properly avoid or set aside the three transfers made by Baker? Was the trustee correct by including in the debtor’s estate rents on the warehouse and the property received as a result of the final divorce decree?
• Walton seeks a denial of Skidmore’s discharge since Skidmore obtained credit from him by use of a fraudulent financial statement.
• Harper claims a priority for the amount owed him which was not satisfied as a result of his resorting to the collateral securing his loan.

Required: Answer the following, setting forth reasons for any conclusions stated.
1. What are the principal avoiding powers of the trustee in bankruptcy?
2. Discuss in separate paragraphs each of the various claims and assertions stated above.

N81
Number 4

Number 4 consists of two unrelated parts.

V. Government Regulation of Business

B. Federal Securities Acts

N83
Number 3

Number 3 consists of two unrelated parts.

Part b. Smith Corp. proposed to merge with Jones, Inc. The stock of both corporations was listed on a national securities exchange. In connection with the merger, both corporations distributed to their shareholders proxy statements seeking their favorable votes. The shareholders of both corporations overwhelmingly voted in favor of the merger. Following the vote, but before consummation of the merger, the stock of Jones dropped substantially in value, from $10 per share to $5 per share.

The reason for the fall in value was the discovery that Smith Corp. had entered into several highly unprofitable long-term contracts. The contracts, which were not disclosed in the proxy statement, will result in substantial losses from Smith’s operations in the coming years. The proxy statements indicate that Smith expected continued profitability for the years in question.

West, a long-time Jones shareholder, opposes the merger and decided to bring legal action under the Securities Exchange Act of 1934.

Required: Answer the following, setting forth reasons for any conclusions stated.
1. Will West prevail, and if so, what remedy or remedies will be available to him?

N82
Number 4

Number 4 consists of two unrelated parts.

Part b. Powell Corporation, which owns 5% of the stock of Baron, Inc., approached the board of directors and several of the principal shareholders of Baron to see if they were willing to sell to Powell their effective controlling interest. Baron is listed on the American Stock Exchange and its management either owns or has the unquestioned support of approximately 37% of the shares outstanding. Baron’s board and the shareholders who were contacted rejected Powell’s overtures. Powell is now considering waging a proxy fight to obtain effective control of Baron.

Required: Answer the following, setting forth reasons for any conclusions stated.
1. Can Baron lawfully refuse to give Powell access to the list of shareholders?
2. What rights does Powell have under the Securities Exchange Act of 1934 to have its proxy materials distributed to shareholders?
3. What major requirements under the Securities Exchange Act of 1934 must be met by both sides in a proxy fight?

N82
Number 2 (Estimated time — 15 to 20 minutes)

Various Enterprises Corporation is a medium sized conglomerate listed on the American Stock Exchange. It is constantly in the process of acquiring smaller cor-
Selected Questions

The committees have submitted a proposal incorporating the above to their respective boards of directors. Both corporations are incorporated in the same state and this state has adopted the Model Business Corporation Act. Cardinal has only one class of stock outstanding, 250,000 shares of common. Diversified has 2,000,000 shares of $1 par value common stock authorized of which 700,000 shares are outstanding. The preferred stock would be a new class of stock with a $5 par value. Diversified is in the lower 20th percentile of the Fortune 500 companies and is listed on the New York Stock Exchange. Cardinal is considerably smaller with assets of $11 million and sales of $4 million. It is traded in the over-the-counter market. Diversified does not compete with, nor does it buy from or sell to, Cardinal. The form of the acquisition is to be a statutory merger.

You have been assigned to an accounting team to provide assistance to Diversified in this undertaking.

Required: Answer the following, setting forth reasons for any conclusions stated.

1. In separate paragraphs, discuss the requirements of the Securities Act of 1933 arising out of the above facts as well as federal antitrust implications.
2. From a corporate law standpoint, what must be done to validly consummate the proposed merger?

Part b. During the initial audit of Haskell Corporation, a medium-sized company engaged in interstate commerce, the CPA discovers that Haskell has recently instituted a generous and broadly-based employees' stock purchase plan. Haskell's philosophy is based upon maximum participation by all employees. This philosophy is generally stated in Haskell's employment brochures and has been fully implemented. Haskell employs approximately 13,000 people in plants located in several states. Approximately 95% of the employees are participating in the plan.

Required: Answer the following, setting forth reasons for any conclusions stated.

Does the Securities Act of 1933 pose any problems to Haskell in connection with its employees' stock purchase plan or can it claim an exemption as a private placement?

M81

Number 4 (Estimated time — 15 to 20 minutes)

Part a. Delwood is the Central American representative of Massive Manufacturing, Inc., a large diversified conglomerate listed on the New York Stock Exchange. Certain key foreign government and large foreign manufacturing company contracts were in the crucial stages of bidding and negotiation. During this crucial time, Feldspar, the CEO of Massive, summoned Delwood to the company's home office for an urgent consultation. At the meeting, Feldspar told Delwood that corporate sales and profits were lagging and something definitely had to be done. He told Delwood that

corporations and is invariably in need of additional money. Among its diversified holdings is a citrus grove which it purchased eight years ago as an investment. The grove’s current fair market value is in excess of $2 million. Various also owns 800,000 shares of Resistance Corporation which it acquired in the open market over a period of years. These shares represent a 17% minority interest in Resistance and are worth approximately $2½ million. Various does its short-term financing with a consortium of banking institutions. Several of these loans are maturing; in addition to renewing these loans, it wishes to increase its short-term debt from $3 to $4 million.

In light of the above, Various is considering resorting to one or all of the following alternatives in order to raise additional working capital.

- An offering of 500 citrus grove units at $5,000 per unit. Each unit would give the purchaser a 0.2% ownership interest in the citrus grove development. Various would furnish management and operation services for a fee under a management contract and net proceeds would be paid to the unit purchasers. The offering would be confined almost exclusively to the state in which the groves are located or in the adjacent state in which Various is incorporated.

- An increase in the short-term borrowing by $1 million from the banking institution which currently provides short-term funds. The existing debt would be consolidated, extended and increased to $4 million and would mature over a nine month period. This would be evidenced by a short-term note.

- Sale of the 17% minority interest in Resistance Corporation in the open market through its brokers over a period of time and in such a way so as to minimize decreasing the value of the stock. The stock is to be sold in an orderly manner in the ordinary course of the broker's business.

Required: Answer the following, setting forth reasons for any conclusions stated.

In separate paragraphs discuss the impact of the registration requirements of the Securities Act of 1933 on each of the above proposed alternatives.

M81

Number 2 (Estimated time — 15 to 20 minutes)

Part a. Diversified Enterprises, Inc. and Cardinal Manufacturing Corporation have each appointed a committee to discuss Diversified's proposed acquisition of Cardinal. After protracted bargaining, the two committees have agreed to the following terms: Diversified would acquire Cardinal in exchange for 500,000 shares of Diversified's voting common stock and 250,000 shares of its 11% noncumulative, nonvoting preferred.

The committees have submitted a proposal incorporating the above to their respective boards of directors. Both corporations are incorporated in the same state and this state has adopted the Model Business Corporation Act. Cardinal has only one class of stock outstanding, 250,000 shares of common. Diversified has 2,000,000 shares of $1 par value common stock authorized of which 700,000 shares are outstanding. The preferred stock would be a new class of stock with a $5 par value. Diversified is in the lower 20th percentile of the Fortune 500 companies and is listed on the New York Stock Exchange. Cardinal is considerably smaller with assets of $11 million and sales of $4 million. It is traded in the over-the-counter market. Diversified does not compete with, nor does it buy from or sell to, Cardinal. The form of the acquisition is to be a statutory merger.

You have been assigned to an accounting team to provide assistance to Diversified in this undertaking.

Required: Answer the following, setting forth reasons for any conclusions stated.

1. In separate paragraphs, discuss the requirements of the Securities Act of 1933 arising out of the above facts as well as federal antitrust implications.
2. From a corporate law standpoint, what must be done to validly consummate the proposed merger?

Part b. During the initial audit of Haskell Corporation, a medium-sized company engaged in interstate commerce, the CPA discovers that Haskell has recently instituted a generous and broadly-based employees' stock purchase plan. Haskell's philosophy is based upon maximum participation by all employees. This philosophy is generally stated in Haskell's employment brochures and has been fully implemented. Haskell employs approximately 13,000 people in plants located in several states. Approximately 95% of the employees are participating in the plan.

Required: Answer the following, setting forth reasons for any conclusions stated.

Does the Securities Act of 1933 pose any problems to Haskell in connection with its employees' stock purchase plan or can it claim an exemption as a private placement?

M81

Number 4 (Estimated time — 15 to 20 minutes)

Part a. Delwood is the Central American representative of Massive Manufacturing, Inc., a large diversified conglomerate listed on the New York Stock Exchange. Certain key foreign government and large foreign manufacturing company contracts were in the crucial stages of bidding and negotiation. During this crucial time, Feldspar, the CEO of Massive, summoned Delwood to the company's home office for an urgent consultation. At the meeting, Feldspar told Delwood that corporate sales and profits were lagging and something definitely had to be done. He told Delwood that
his job was on the line and that unless major contracts were obtained, he would have to reluctantly accept his resignation. Feldspar indicated he was aware of both the competition and the legal problems that were involved. Nevertheless, he told Delwood "do what is necessary in order to obtain the business." Delwood flew back to Central America the next day and began to implement what he believed to be the instructions he had received from Feldspar. He first contacted influential members of the ruling parties of the various countries and indicated that large discretionary contributions to their re-election campaign funds would be forthcoming if Massive's bids for foreign government contracts were approved. Next, he contacted the large foreign manufacturers and indicated that loans were available to them on a non-repayment basis if they placed their business with Massive. These payments were to be accounted for by charging certain nebulous accounts or by listing the payments as legitimate loans to purchasers. In any event, the true nature of the expenditures was not to be shown on the books. All this was accomplished, and Massive's sales improved markedly in Central America.

Two years later the Securities and Exchange Commission discovered the facts described above.

Required: Answer the following, setting forth reasons for any conclusions stated.

What are the legal implications of the above to Delwood, Feldspar, and Massive Manufacturing?

Part b. Marigold Corporation is incorporated in one of the states of the United States and does substantially all of its business within that state. It is considering reliance upon the intrastate exemption to the Securities Act of 1933 in order to offer and sell its securities without registering them under the 1933 Act. Its proposed offering will consist of $800,000 of common stock and $1 million of debentures. Most of the people it has talked to about the feasibility of such an offering are very wary of such a course of action and warn of significant limitations and dangers inherent in such action.

Required: Answer the following, setting forth reasons for any conclusions stated.
1. What are the requirements, limitations, and problems that are typically encountered in an intrastate offering?
2. Even if the Securities Act's requirements for the exemption can be satisfied, what must be done from the standpoint of state law?

VI. Uniform Commercial Code

A. Commercial Paper

N83
Number 2

Number 2 consists of two unrelated parts.

Part b. Hardy & Company was encountering financial difficulties. Melba, a persistent creditor whose account was overdue, demanded a check for the amount owed to him. Hardy's president said that this was impossible since the checking account was already overdrawn. However, he indicated he would be willing to draw on funds owed by one of the company's customers. He drafted and presented to Melba the following instrument.

```
October 1, 1983
TO:
Stitch Fabrications, Inc.
2272 University Avenue
Pueblo, Colorado 81001

Pay Hardy & Company, ONE THOUSAND and no/100 dollars ($1,000.00) 30 days after acceptance, for value received in connection with our shipment of August 11, 1983.

Hardy & Company
by [Signature]
242 Oak Lane Drive
Hinsdale, Illinois 60521

Accepted by: [Signature]
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B-80
Selected Questions

Hardy endorsed the instrument on the back as follows:

```
Pay to the order of Walter Melba
Hardy & Company

[Signature]
President
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Melba asserts that he is a holder in due course.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What type of instrument is the above? How and in what circumstances is it used?
2. Is it negotiable?
3. Assume that the instrument is negotiable and accepted by Stitch, but prior to payment, Stitch discovers the goods are defective. May Stitch successfully assert this defense against Melba to avoid payment of the instrument?

**M83**
**Number 5**

Number 5 consists of two unrelated parts.

**Part a.** Dunhill fraudulently obtained a negotiable promissory note from Beeler by misrepresentation of a material fact. Dunhill subsequently negotiated the note to Gordon, a holder in due course. Pine, a business associate of Dunhill, was aware of the fraud perpetrated by Dunhill. Pine purchased the note for value from Gordon. Upon presentment, Beeler has defaulted on the note.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the rights of Pine against Beeler?
2. What are the rights of Pine against Dunhill?

**M81**
**Number 2 (Estimated time — 15 to 20 minutes)**

**Part a.** Oliver gave Morton his 90-day negotiable promissory note for $10,000 as a partial payment for the purchase of Morton’s business. Morton had submitted materially false unaudited financial statements to Oliver in the course of establishing the purchase price of the business. Morton also made various false statements about the business’ value. For example, he materially misstated the size of the backlog of orders. Morton promptly negotiated the note to Harrison who purchased it in good faith for $9,500, giving Morton $5,000 in cash, a check for $3,500 payable to him which he indorsed in blank and an oral promise to pay the balance within 5 days. Before making the final payment to Morton, Harrison learned of the fraudulent circumstances under which the negotiable promissory note for $10,000 had been obtained. Morton has disappeared and the balance due him was never paid. Oliver refuses to pay the note.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In the subsequent suit brought by Harrison against Oliver, who will prevail?

**Part b.** McCarthy, a holder in due course, presented a check to the First National Bank, the drawee bank named on the face of the instrument. The signature of the drawer, Williams, was forged by Nash who took the check from the bottom of Williams’ check book along with a cancelled check in the course of burglarizing Williams’ apartment. The bank examined the signature of the drawer carefully, but the signature was such an artful forgery of the drawer’s signature that only a handwriting expert could have detected a difference. The bank therefore paid the check. The check was promptly returned to Williams, but he did not discover the forgery until thirteen months after the check was returned to him.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Williams seeks to compel the bank to credit his account for the loss. Will he prevail?
2. The facts are the same as above, but you are to assume that the bank discovered the forgery before returning the check to Williams and credited his account. Can the bank in turn collect from McCarthy the $1,000 paid to McCarthy?
3. Would your answers to 1 and 2 above be modified if the forged signature was that of the payee or an indorser rather than the signature of the drawer?

**C. Sales**

**M85**
**Number 2 (Estimated time — 15 to 20 minutes)**

Reed, a manufacturer, entered into an oral contract with Rocco, a retailer, to deliver 10 leather jackets to Rocco’s place of business within 15 days. The total sales price was $450. Prior to the delivery of the jackets the market price of leather increased drastically. Reed knew Rocco needed the jackets within the 15 days and telephoned Rocco stating that he would be unable to deliver the jackets unless the sales price was increased by $100. Rocco agreed to the new price. The following morning Reed sent Rocco a signed letter indicating the new sales price and that the sale was for 10 leather jackets. Rocco received the letter the next day and has taken no further action.

Reed entered into an oral contract to purchase Smith’s vacant building for $50,000, giving $5,000 as a deposit. The parties intended to reduce their agreement to writing at a later date. Pursuant to the oral contract, Reed took possession of the building with Smith’s per-
mission and made permanent and substantial improvements. Due to a rise in the price of similar real estate, Smith serves notice on Reed to vacate the premises, contending that the sales contract was unenforceable.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

- Discuss whether the original sales contract and the subsequent change in price by Reed are enforceable under the UCC Sales Article.
- May Smith require Reed to vacate the building?

**M83**  
**Number 5**

Number 5 consists of two unrelated parts.

**Part b.** Dennison Corporation, a Los Angeles-based manufacturer, recently ordered some hardware from Elba Corporation, a Boston-based seller of fine tools. Unfortunately, all of the hardware was destroyed while in transit by the carrier. Further examination revealed that while one set of tools was shipped under terms f.o.b. Los Angeles, the other set was shipped under terms f.o.b. Boston.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Which party will bear the risk of loss for each set of tools destroyed in transit assuming conforming goods were shipped?
2. Assume that Dennison also purchased some tools from San Francisco-based Drew Corporation which were shipped under terms f.o.b. San Francisco. The property is found defective upon arrival in Los Angeles. Which party will bear the risk of loss if the property is destroyed immediately after receipt?

**M82**  
**Number 5 (Estimated time — 15 to 20 minutes)**

**Part a.** Sure Rain Apparel, Inc., manufactures expensive, exclusive rain apparel. One model is very popular and sold widely throughout the United States. About six months after their initial sale to distributors, Sure started receiving complaints that there was a noticeable fading of the color of the material. Many of the distributors seek to return the goods, recover damages, or both. Sure denies liability on the following bases: (1) there was an “Act of God,” (2) there was no breach of warranty since the fading was to be expected in any event, and (3) any and all warranty protection was disclaimed unless expressly stated in the contract.

The contract contained the following provisions relating to warranty protection:

First: The manufacturer warrants that the material used to make the raincoats is 100% Egyptian long fiber cotton.

Second: The manufacturer guarantees the waterproofing of the raincoat for one year if the directions as to dry cleaning are followed.

Third: There are no other express warranties granted by the seller, except those indicated above. This writing is intended as a complete statement and integration of all express warranty protection.

Fourth: The manufacturer does not purport to give any implied warranty of merchantability in connection with this sale. The express warranties above enumerated are granted in lieu thereof.

Fifth: There are no warranties which extend beyond the description above.

The fourth and fifth provisions were conspicuous and initialed by the buyers.

Several buyers have commenced legal actions against Sure based upon implied warranties and express oral warranties made prior to the execution of the contract.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Is Sure liable for breach of warranty?

**Part b.** Nielson Wholesalers, Inc. ordered 1,000 scissors at $2.50 a pair from Wilmot, Inc., on February 1, 1982. Delivery was to be made not later than March 10. Wilmot accepted the order in writing on February 4. The terms were 2/10, net/30, f.o.b. seller’s loading platform in Baltimore. Due to unexpected additional orders and a miscalculation of the backlog of orders, Wilmot subsequently determined that it could not perform by March 10. On February 15, Wilmot notified Nielson that it would not be able to perform, and cancelled the contract. Wilmot pleaded a reasonable mistake and impossibility of performance as its justification for cancelling. At the time the notice of cancellation was received, identical scissors were available from other manufacturers at $2.70. Nielson chose not to purchase the 1,000 scissors elsewhere, but instead notified Wilmot that it rejected the purported cancellation and would await delivery as agreed. Wilmot did not deliver on March 10, by which time the price of the scissors had risen to $3.00 a pair. Nielson is seeking to recover damages from Wilmot for breach of contract.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Will Nielson prevail and, if so, how much will it recover?
2. Would Nielson be entitled to specific performance under the circumstances?
3. Assuming that Wilmot discovers that Nielson was insolvent, will this excuse performance?
N81
Number 5

Number 5 consists of two unrelated parts.

Part b. Maxwell was window shopping one day when she noticed an advertisement at Ultraclear Electronics for the sale of a shortwave radio for $495. Beneath the large caption indicating the sale and the price were the following:

- Never sold before below $550.
- Listen to the BBC, Radio Moscow, Radio Tokyo, and other international radio stations.
- Easy tuning, great reception, and made of the highest quality material.
- Don’t hesitate, this is a limited offer on the buy of a lifetime.

Maxwell entered the store and proceeded to the place where the shortwave radio featured in the window was displayed with a similar although smaller sign extolling the virtues of the radio. Maxwell was examining the radio when Golden, an Ultraclear salesman, approached her. Maxwell told Golden that she was a great music lover and that she had long wished to listen to the Moscow symphony, the Moscow opera, and the music of the Bolshoi Ballet. Golden merely nodded his head and smiled knowingly. Golden said that at this price the company could not afford to give any implied warranties of quality beyond the replacement of defective parts for ninety days.

When Maxwell got home and used the radio she found it to be in proper working order and that the shortwave reception was satisfactory for much of the world, but that it was not capable of picking up Moscow without severe static and at an exceptionally low audio level. Maxwell returned to Ultraclear and demanded that the radio be put in proper working order. The complaint department told her there was nothing that they could do about it, that the set was in proper working order and the fact that reception of Radio Moscow was poor was something she would just have to live with. Maxwell asserted that there has been a breach of warranty and demanded her money back. This was refused. Ultraclear’s agent then informed Maxwell that she had no warranty protection. The company never “guaranteed” or “warranted” anything. In fact, the only thing stated with respect to warranties at all was Golden’s remark clearly disclaiming any and all warranties.

Required: Answer the following, setting forth reasons for any conclusions stated.

In the subsequent suit brought by Maxwell against Ultraclear to rescind the sale, who will prevail?

D. Secured Transactions

N84
Number 4 (Estimated time — — 15 to 20 minutes)

Tom Sauer purchased a computer and a stereo from Zen Sounds, Inc., for personal use. With regard to the computer, Sauer signed an installment purchase note and a security agreement. Under the terms of the note Sauer was to pay $100 down and $50 a month for 20 months. The security agreement included a description of the computer. However, Zen did not file a financing statement. Sauer paid $800 cash for the stereo.

Two months later, Sauer sold the computer to Ralph for $600 cash. Ralph purchased the computer for personal use without knowledge of Zen’s security interest.

Three months later, Sauer brought the stereo back to Zen for repair. Inadvertently, one of Zen’s salespersons sold the stereo to Ned, a buyer in the ordinary course of business.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Did Zen fulfill the requirements necessary for the attachment and perfection of its security interest in the computer?

b. Will Ralph take the computer free of Zen’s security interest?

c. As between Sauer and Ned, who has title to the stereo?

N83
Number 2

Number 2 consists of two unrelated parts.

Part a. Despard Finance Company is a diverse, full-line lending institution. Its “Problems & Potential Litigation” file revealed the following disputes involving loans extended during the year of examination.

- Despard loaned Fish $4,500 to purchase a $5,000 video recording system for his personal use. A note, security agreement, and financing statement, which was promptly filed, were all executed by Fish. Unknown to Despard, Fish had already purchased the system from Zeals Department Stores the previous day for $5,000. The terms were 10% down, the balance monthly, payable in three years, and a written security interest granted to Zeals. Zeals did not file a financing statement until default.

- Despard loaned Moderne Furniture Co. $13,000 to purchase certain woodworking
equipment. Moderne did so. A note, security agreement, and financing statement were executed by Moderne. As a result of an oversight the financing statement was not filed until 30 days after the loan-purchase by Moderne. In the interim Moderne borrowed $11,000 from Apache National Bank using the newly purchased machinery as collateral for the loan. A financing statement was filed by Apache five days prior to Despard's filing.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What are the priorities among the conflicting security interests in the same collateral claimed by Despard and the other lenders?

**M81**

**Number 3 (Estimated time — 15 to 20 minutes)**

**Part a.** Walpole Electric Products, Inc. manufactures a wide variety of electrical appliances. Walpole uses the consignment as an integral part of its marketing plan. The consignments are "true" consignments rather than consignments intended as security interests. Unsold goods may be returned to the owner-consignor. Walpole contracted with Petty Distributors, Inc., an electrical appliance wholesaler, to market its products under this consignment arrangement. Subsequently, Petty became insolvent and made a general assignment for the benefit of creditors. Klinger, the assignee, took possession of all of Petty's inventory, including all the Walpole electrical products. Walpole has demanded return of its appliances asserting that the relationship created by the consignment between itself and Petty was one of agency and that Petty never owned the appliances. Furthermore, Walpole argues that under the consignment arrangement there is no obligation owing by Petty at any time, thus there is nothing to secure under the secured transactions provisions of the Uniform Commercial Code. Klinger has denied the validity of these assertions claiming that the consignment is subject to the Code's filing provisions unless the Code has otherwise been satisfied. Walpole sues to repossess the goods.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. What are the requirements, if any, to perfect a true consignment such as discussed above?
2. Will Walpole prevail?

**Part b.** Lebow Woolens, Inc. sold several thousand bolts of Australian wool on credit to Fashion Plate Exclusives, Inc., a clothing manufacturer, obtaining a duly executed security agreement and a financing statement. Fashion Plate became delinquent in meeting its payments. Lebow subsequently discovered that a miscaptioned financing statement for a $12,500 sale had been filed under the name of Fashion Styles Limited, another customer. Lebow took the following actions. First, on August 11, 1980, it repossessed the bolts of wool which were not already altered by Fashion Plate. This amounted to some 65% of the invoice in question. Next on August 20, 1980, it filed a corrected financing statement covering the sale in question. Dunbar, another creditor of Fashion Plate's, levied against Fashion Plate's inventory, work in process, and raw materials on August 13th and obtained a judgment of $14,000 against Fashion Plate, an amount in excess of the value of the Lebow bolts of wool. The judgment was obtained and entered on August 18, 1980. Dunbar asserts its rights as a lien judgment creditor.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

In a lawsuit to determine the rights of the parties, how should the competing claims of Lebow and Dunbar be decided?

**VII. Property**

**A. Real and Personal Property**

**M84**

**Number 4 (Estimated time — 15 to 20 minutes)**

Ted and his wife Judy own Redacre in a tenancy by the entirety. Redacre is a lot by the seaside on which they plan someday to build a summer home. Ted also owns Bigacre in a joint tenancy with Lois, Clark, and Jeff, each owning a ¼ undivided interest. Bigacre is a large parcel of investment acreage which produces no current income. Ted and Judy have had several arguments about the raising of their son Peter, now age 18, who Judy believes has exhibited a tendency toward irresponsibility. Ted, as a result, has decided to take certain steps on his own to protect Peter's future financial security.

Ted plans to establish a trust with Guardem Trust Company and Peter as co-trustees. He plans to transfer Redacre to the trust along with $100,000 in cash. The $100,000 is to be used to purchase Ted's interest in Bigacre. Although Judy knows of the steps being taken, she has not agreed to them. Accordingly, Ted does not plan to have her participate in the establishment of the trust or in any of the transactions or paperwork involved.

The trust will provide that all income is to be paid to Peter, with final distribution of all trust assets to Peter upon his reaching age 40. The trust will also permit Peter, after reaching age 21, to remove Guardem as trustee leaving himself as successor sole trustee.
Required: Answer the following, setting forth reasons for any conclusions stated.

If Ted's plans are carried out:
1. What interest will the trust have in Redacre and Bigacre?
2. What interests will the remaining three parties have in Bigacre, if Clark dies subsequent to the transfer of Ted's interest in Bigacre to the trust?
3. Will the requirements of a valid trust be met?
4. Will the purchase of Bigacre from Ted be a proper exercise of the trustees' duties?
5. What effect would Peter's exercise of his right to remove Guardem as a trustee after he reaches 21, have on the trust and the ownership of Bigacre?

N82
Number 5

Number 5 consists of two unrelated parts.

Part b. Darby Corporation, a manufacturer of power tools, leased a building for 20 years from Grayson Corporation commencing January 1, 1981. During January 1981, Darby affixed to the building a central air conditioning system and certain heavy manufacturing machinery, each with an estimated useful life of 30 years.

While auditing Darby's financial statements for the year ended December 31, 1981, the auditor noted that Darby was depreciating the air conditioning equipment and machinery, for financial accounting purposes, over their estimated useful lives of 30 years. In reading the lease, the auditor further noted that there was no provision with respect to the removal by the lessee of the central air conditioning system or machinery upon expiration of the lease. To verify that the appropriate estimated useful lives are being utilized for recording depreciation, the auditor is interested in establishing the rightful ownership of these assets upon the expiration of the lease. The auditor knows that in order to determine ownership of the assets at the expiration of the lease, one must first determine whether the assets would be considered personalty or realty.

Required: Answer the following, setting forth reasons for any conclusions stated.

What major factors would likely be considered by a court in determining whether the air conditioning system and the machinery are to be regarded as personalty or realty, and what would be the likely determination with respect to each?

B. Mortgages

N84
Number 2 (Estimated time — 15 to 20 minutes)

Joe Fine, a clothing manufacturer for the past 30 years, owns a plant on which Muni Bank holds a mortgage. He also leases a warehouse from Jay Co. in which he stores the clothing manufactured in the plant. There are 10 years remaining on the lease term. Fine plans to move his operations to another location and has decided to sell to Bean his interests in the plant and lease.

Fine is contemplating selling the plant to Bean under one of the following conditions:

- Bean taking the plant subject to the mortgage.
- Bean assuming the mortgage on the plant.
- Fine obtaining a duly executed novation from Muni and Bean.

The lease contains a clause prohibiting assignment to third parties. Fine is concerned with this clause as well as his continuing liability to Jay upon the transfer of his interests in the lease to Bean. In this regard, Fine asserts that:

- The clause prohibiting the assignment of the lease is void.
- The prohibition against assignment will not affect his right to sublease.
- He will be released from liability to pay rent upon obtaining Jay's consent either to sublet or to assign.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. In separate paragraphs, discuss Fine's and Bean's liability to Muni under each of the three aforementioned conditions relating to the mortgage, if Bean after purchasing the plant defaults on the mortgage payments, thereby creating a deficiency after a foreclosure sale.

b. In separate paragraphs, comment on Fine's assertions regarding the lease, indicating whether such assertions are correct and the reasons therefor.

N81
Number 4

Number 4 consists of two unrelated parts.

Part b. Vance Manufacturing, Inc., needed an additional plant location. The executive committee of Vance made a survey to determine what property was available and to select the most desirable location. After much deliberation, Vance decided to purchase a four-acre tract of land belonging to Dave Lauer. Lauer was in financial difficulty and desperately needed to raise money. Vance felt that the asking price of $70,000 was too high and that Lauer would come down to $60,000 in light of his financial difficulties. After much negotiation, Lauer agreed to sell for $61,000. Vance's attorney promptly examined Lauer's title to the property and found that a $40,000 mortgage had recently been filed by Second Bank & Trust Company. Lauer had mentioned this and indicated that the mortgage would be satisfied out of the $61,000 sale price. The
title search, completed on February 2, 1981, revealed that Lauer’s title was otherwise clear. Closing was scheduled for March 1.

Meanwhile, desperate for additional financing, Lauer had been negotiating a second mortgage with Adventure Mortgage Company. Lauer did not reveal to Adventure that he was in the process of selling the property to Vance, nor did he tell Vance about the second mortgage. Adventure loaned Lauer $10,000 on February 20 and took a second mortgage on the property. This mortgage was filed by Adventure on February 22. Vance’s attorney made a cursory final examination of the title on February 20, and the parties proceeded to close on March 1 as scheduled. Lauer promptly cashed his check for $21,000 and disappeared. Adventure is demanding that it be paid by Vance and threatens foreclosure of its second mortgage.

Required: Answer the following, setting forth reasons for any conclusions stated.

Discuss the legal rights and liabilities of each of the parties involved in the above situation.

C. Fire and Casualty Insurance

Number 5

Number 5 consists of two unrelated parts.

Part a. While auditing the financial statements of Jackson Corporation for the year ended December 31, 1981, Harvey Draper, CPA, desired to verify the balance in the insurance claims receivable account. Draper obtained the following information:

- On November 4, 1981, Jackson’s Parksdale plant was damaged by fire. The fire caused $200,000 damage to the plant, which was purchased in 1970 for $600,000. When the plant was purchased, Jackson obtained a loan secured by a mortgage from Second National Bank of Parksdale. At the time of the fire the loan balance, including accrued interest, was $106,000. The plant was insured against fire with Eagle Insurance Company. The policy contained a “standard mortgagee” clause and an 80% coinsurance clause. The face value of the policy was $600,000 and the value of the plant was $1,000,000 at the time of the fire.

- On December 10, 1981, Jackson’s Yuma warehouse was totally destroyed by fire. The warehouse was acquired in 1965 for $300,000. At the time of the fire, the warehouse was unencumbered by any mortgage; it was insured against fire with Eagle for $300,000; and it had a value of $500,000. The policy contained an 80% coinsurance clause.

- On December 26, 1981, Jackson’s Rye City garage was damaged by fire. At the time of the fire, the garage had a value of $250,000 and was unencumbered by any mortgage. The fire caused $60,000 damage to the garage, which was constructed in 1965 at a cost of $50,000. In 1975 Jackson expanded the capacity of the garage at an additional cost of $50,000. When the garage was constructed in 1965, Jackson insured the garage against fire for $50,000 with Eagle, and this policy was still in force on the date of the fire. When the garage was expanded in 1975, Jackson obtained $100,000 of additional fire insurance coverage from Queen Insurance Company. Each policy contains an 80% coinsurance clause and a standard pro-rata clause.

Required: Answer the following, setting forth reasons for any conclusions stated.

1. How much of the fire loss relating to the Parksdale plant will be recovered from Eagle?
2. How will such recovery be distributed between Second National and Jackson?
3. How much of the fire loss relating to the Yuma warehouse will be recovered from Eagle?
4. How much of the fire loss relating to the Rye City garage will be recovered from the insurance companies?
5. What portion of the amount recoverable in connection with the Rye City garage loss will Queen be obligated to pay?
SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. The CPA and the Law

M85
Answer 4 (10 points)

a. The bases for shareholders' and creditors' suits against Arthur & Doyle under federal securities acts include

- That a violation of the 1933 act has occurred as a result of misstatements or omissions in the prospectus or elsewhere in the registration statement required in order to "sell" the securities. The Securities and Exchange Commission has ruled that the issuance and exchange of stock pursuant to a merger constitutes a "sale" within the meaning of the Securities Act of 1933.
- That a violation of the anti-fraud provisions of the 1934 act and of Rule 10b-5 issued pursuant thereto has occurred since misstatements and omissions of material facts may be fraudulent. Additionally, the anti-fraud provision (Sec. 17) of the 1933 act could be asserted.
- That a violation of the reporting requirements of the Securities Exchange Act of 1934 has occurred to the extent that false or misleading statements were included or material facts were omitted in the reports or other documents relating to the merger and which were filed with the SEC.
- That a violation of the proxy rules of the Securities Exchange Act of 1934 resulted from misstatements in or omissions from the merger proxy statement used in soliciting shareholder approval.

b. The bases for shareholders' and creditors' suits against Arthur & Doyle under state common law include

- Breach of contract. The relationship between Arthur & Doyle and Dunbar is contractual and requires that the CPAs' performance be rendered in a competent manner. The shareholders and creditors may claim breach of contract as third-party beneficiaries of the contract between the CPAs and Dunbar, since it could be held that the contract was entered into for their benefit and therefore they are in privity with the CPAs.
- Negligence. The shareholders and creditors could assert an independent claim of negligence in addition to the action for breach of contract. Negligence will be established when the CPAs fail to exercise reasonable care, taking into account such superior skill and knowledge the CPAs have or hold themselves out as having. Despite their lack of contractual privity, the shareholders and creditors will probably be able to successfully assert this action if they can show that they are members of a class of persons intended to benefit from the services performed by the CPAs and that this was reasonably foreseeable by the CPAs.
- Actual fraud or constructive fraud. Recent court decisions have substantially eroded the privity barrier faced by third parties. Arthur & Doyle may be held liable for actual fraud if it can be shown that they intentionally deceived the shareholders and creditors. Arthur & Doyle may be held liable for constructive fraud if there are deficiencies or lapses in their professional work of such a magnitude that they constitute gross negligence or a reckless disregard for the truth.

M84
Answer 2 (10 points)

1. Privity is an early common law concept that was adopted by the courts to prevent third parties from bringing a legal action based upon a contract to which they were not parties. William was in privity of contract with Perfect, its audit client, but William had no contractual relationship with Capitol despite Capitol's reliance upon the statements audited by William. Moreover, Capitol gave no consideration to William. Therefore, under strict application of the privity rule, Capitol lacks the standing to sue for breach of contract or negligence since Capitol is not in a direct contractual relationship with William.

Privity has been the subject of much critical re-evaluation, and the courts have frequently narrowed or rejected it. However, in a landmark opinion (Ultra-mares), privity was retained to some extent in an action against a CPA firm based partially upon negligence. Some court decisions, however, have directly overruled
the privity defense in actions against CPAs, particularly when the third party was contemplated as a user of the financial statements, as in this case.

2. The first major exception to the privity requirement is fraud. Although a CPA may generally avoid liability for ordinary negligence based upon privity, where the action is for fraud, an injured third party has the requisite standing to sue. However, in order to recover based on fraud, the third party (Capitol) must prove scienter or guilty knowledge on the part of the CPA.

The second exception to the privity defense is constructive fraud. Constructive fraud is generally defined as a false representation of a material fact with lack of reasonable ground for belief and with an expectation of reliance by another, and, in fact, there is reasonable reliance resulting in damage. Constructive fraud may also be inferred from evidence of gross negligence or recklessness, although they are not necessarily constructive fraud in and of themselves. The dividing line between what actions will meet the scienter requirement for actual fraud and what is necessary to evoke the constructive fraud doctrine is not clear.

The third exception to the privity defense is gross negligence. Gross negligence represents an extreme, flagrant, or reckless departure from standards of due care. For example, a knowing failure to follow GAAS on a material matter might be held by a jury to be gross negligence. The jury might then find that the defendant’s conduct was so gross as to satisfy the scienter requirement.

In addition to fraud and its various offshoots, one may avoid the privity barrier if it can be established by the third party that it was the party that the contract was intended to benefit. Thus, if a third party plaintiff suing a CPA can establish that the audit was for his benefit, then the injured third party may have standing to sue. He is a third party beneficiary of the contract and privity will not bar him from recovery. Recovery under this theory has been significantly expanded. It has recently been held that liability extends to those in a fixed, definable, and contemplated group whose conduct is to be governed by the contract’s performance.

implied civil damage remedy is available to Peters against Doe.

Although Doe was negligent, the United States Supreme Court, in the Hochfelder case, held that a violation of rule 10b-5 requires scienter, something greater than mere negligence. Unless the violation of GAAS involves intent, or gross negligence, Doe would not be held in violation of rule 10b-5.

Similarly, Peters might claim a remedy against Doe for violation of section 17 of the 1933 Securities Act. The Supreme Court, in the Aaron case, held no scienter is required in certain section 17 cases brought by the SEC, but it appears that private actions, such as the one by Peters, would be subject to provisions similar to those in rule 10b-5.

2. No. Peters will not prevail based upon his state common law action either. At common law, privity is required before an accountant can be held liable to users of the financial statements, absent fraud. Doe was not in privity of contract with Peters, nor does the question indicate that Doe was even aware that Peters would rely on the financial statements.

Part b.

Yes. Ira will prevail and recover damages from Baker. He will base his action on section 11 of the Securities Act of 1933. Section 11 imposes liability on experts, including accountants, whose opinions appear in a registration statement. The experts are liable to all those who in reliance on their opinions purchase securities in a public offering under the 1933 act. Ira does not have to prove Baker was negligent in auditing Able. All he need allege and prove is that there is a material false statement or omission of a material fact in the registration statement. The only defense that Baker may assert is that it exercised the degree of care that would be exercised by certified public accountants in similar circumstances. This is commonly referred to as the “due diligence” defense. Negligence by Baker is therefore a violation of section 11, and makes Baker liable to Ira for his damages.

M83
Answer 2  (10 points)

Part a.

1. No. Peters will not prevail. The facts do not involve liability in the sale of registered securities nor liability for reports filed with the SEC. Because the stock transaction involved interstate commerce, Peters’s claim may be based on section 17 (the antifraud provision) of the Securities Act of 1933 and rule 10b-5 under the Securities Exchange Act of 1934. In either case, he will have to show fraud on the part of Doe, or a manipulative device or scheme, in connection with the sale of a security under the 1933 act or the purchase or sale of a security under the 1934 act. If this can be shown, an

N82
Answer 2  (10 points)

Part a.

1. Yes. Section 32 (a) of the Securities Exchange Act of 1934 provides that any person who “willfully” violates a substantive provision of the 1934 act or any person who “willfully and knowingly” makes, or causes to be made, false or misleading statements in reports required to be filed with the SEC shall be subject to criminal sanctions. The elements of the government’s case would be (1) falsity, that is, the false information included in the Form 10-K; (2) of a “material” fact, satisfied here based on the facts; and (3) criminal intent, as evidenced by the acceptance of the additional $20,000 fee by Danforth as payment for not mentioning

B-88
the CD in his report. To prove criminal intent, it need only be established that Danforth rendered his opinion knowing that the financial statements were false.

2. Yes. The fact that Danforth can establish that no one was damaged will not be a valid defense to the criminal action. The reason is that such damage is not an element of proof in criminal proceedings.

Part b.

Yes. Danforth would be found liable to the bank. According to the facts, the bank made the loan to Blair in reliance on the audit report and financial statements. Danforth’s failure to disclose the subsequently discovered information to the bank, constituted a common law fraud. Danforth had a duty to correct the financial statements, which he knew to be in error and which he knew the bank would rely upon. The necessary fraudulent intent of the auditor may be inferred where, as here, the auditor sits by silently while others rely on his original representations.

Danforth’s performance of his audit in accordance with GAAS did not relieve him of his responsibility to disclose to the bank the fact that the CD was erroneously included in the financial statements. The auditor owes such a duty to third parties, the breach of which constitutes an intentional misrepresentation rather than mere negligence.

M82
Answer 3 (10 points)

Part a.

1. No. Subpoenas issued by the SEC involve the enforcement of federal law. Hence any state statutes concerned with the accountant-client privilege are not applicable. Under federal law, no privilege exists on behalf of CPAs in such proceedings.

2. No. The privilege is designed to preserve the confidentiality of communications between the client and the accountant, that is, to foster a free flow of information. However, statutory privileges may be waived. Producing two of the past ten prior-year audit files would effectively constitute a waiver of the privilege for the remaining eight.

3. Sharp may contend that the subpoenas are “overly broad” in that they call for all of his workpapers for the prior ten years where there is no evidence that Fargo engaged in questionable activities during that period. Sharp may also contend that the subpoenas are onerous or overly burdensome in that he will bear the substantial cost of duplicating the workpapers.

Part b.

Yes. Pelham & James will be found liable to Dickerson and Nichols based on their negligent misrepresentation that the trade accounts payable balance was accurate within $8,000, when in fact it was materially understated. The understatement was due to the firm’s failure to detect certain unpaid bills that were available for their inspection.

It should be recognized that Pelham & James will be liable to Dickerson and Nichols even though they are third-party users of the financial statements and not in privity of contract with Pelham & James. Dickerson’s and Nichols’s reliance, both on the financial statements and on Pelham & James’s oral representations, was specifically known, and, thus, Pelham & James owed them a duty of due care. Moreover, Pelham & James’s compilation report, which disclaimed any opinion or other assurances, will not release them from liability.

N81
Answer 3 (10 points)

Part a.

1. No. Although the normal or typical audit may very well detect defalctions, an auditor’s duty to detect fraud is limited to that which can be detected in the course of a GAAS audit. Nor does the engagement encompass taking the additional steps necessary that might detect a defalcation, unless this is specifically agreed. The engagement in the instant case in no way indicated that it was intended to discover defalcations. Even if McCoy had told Donovan of the anonymous letter, it is doubtful that liability would attach unless there was a negligently performed audit or a specific engagement to detect defalcations that was not properly performed. The fact that McCoy thought the usual audit would automatically include procedures to specifically detect defalcations would not affect the outcome of the case in the absence of additional facts—for example, if Donovan knew of McCoy’s belief. Even assuming negligence on Donovan’s part, recovery by McCoy Forging would be limited to the amount of damages caused by the negligent failure to discover the defalcation. In effect, recovery would be limited to defalcations subsequent to the audit.

2. Yes. The facts raise the question of whether or not McCoy acted as a reasonably prudent person in light of the circumstances. The theory applicable is negligence. McCoy owed the corporation a duty of due care in the performance of his duties as chief executive officer of McCoy Forging. Either the corporation or a shareholder suing derivatively could proceed against McCoy under the negligence theory for failing to disclose the letter and take appropriate action.

Part b.

No. A CPA who engages in a defalcation audit is not an insurer. Liability, if any, must be predicated on fault based on the failure to exercise the care of a reasonable person under the circumstances and in accordance with the special skill or training of that person. As indicated,
recovery for negligence is predicated on fault and, consequently, where there is a defalcation that cannot be discovered even with the exercise of the special care required in the performance of a defalcation audit, there is no liability. This certainly appears to be the case here. Furthermore, the difficulty of detection of the particular scheme is evidenced by the failure of the internal audit to detect anything and by the failure of the company to detect anything until Schultz was caught in the act, even though the company had continuous control of the inventory.

Finally, the excellence of the copies, the near impossibility of detection by physical examination except by an expert, and the identical repackaging, all seem to indicate that the defalcation was such that it would not have been detected even by a carefully and competently executed defalcation audit.

II. Business Organizations

B. Partnerships and Joint Ventures

M84
Answer 5

Part a.

1. An outgoing partner, such as Hart, continues to have potential liability for partnership debts incurred prior to his withdrawal unless he obtains a release from the existing creditors. Hart has no liability for partnership obligations incurred subsequent to his withdrawal provided that appropriate notice is given to the partnership creditors and other third parties. In this case, actual notice was given to the partnership’s creditors in existence at the time of Hart’s withdrawal, but constructive notice (i.e., notice by publication) was not given to those third parties who had not dealt with the partnership but may have known of its existence. By giving the appropriate type of notice, Hart would have effectively eliminated third parties’ rights to rely on Hart’s withdrawal, but constructive notice (i.e., notice by publication) was not given to those third parties who had not dealt with the partnership but may have known of its existence. By giving the appropriate type of notice, Hart would have effectively eliminated third parties’ rights to rely on Hart’s withdrawal. Because constructive notice was not given, creditors or other third parties who deal with the partnership after Hart’s withdrawal may not be aware of his withdrawal and he may be liable to them. However, Hart will not be liable to existing creditors who, after receiving actual notice of Hart’s withdrawal, dealt with the partnership.

2. The Uniform Partnership Act provides that a person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred. However, this liability shall be satisfied only out of partnership property. Therefore, Paul has no personal liability as to partnership obligations existing at the time he became a partner but can be held personally responsible for those debts incurred after his admission as a partner.

N82
Answer 3

Part b.

1. Graham’s spouse would lose in such an action. One of the principal characteristics of a tenancy in partnership is that upon the death of a partner, that partner’s right in specific partnership property vests in the surviving partner or partners. Another characteristic provides that a partner’s right in specific partnership property is not subject to dower, curtesy, or allowances to a surviving spouse, heirs, or next of kin.

2. Yes. Despite the fact that legal title to the real estate remains with Phillips, this is not conclusive evidence that the real estate is not a partnership asset. This is a factual question in which the objective intention of the parties may be inferred by examining a variety of factors such as whether the property was improved with partnership funds, whether expenses relating to the asset (such as insurance and taxes) were paid for by the partnership, and so forth. Since the partnership actually paid the real estate taxes, such property may properly be considered a partnership asset and thus included on its balance sheet.

3. No. Jamison may attach Killian’s partnership interest in the firm by obtaining a charging order (which would, for example, entitle Jamison to receive Killian’s share of the partnership profits) but cannot obtain a fractional interest in any specific item of property.

4. No. The act of every partner for apparently carrying on in the usual course of business the business of the partnership binds the partnership, unless the partner so acting has in fact no authority and the person with whom he is dealing has knowledge of the lack of authority. The acts of Henderson appeared to be in the usual course of business, and there is no indication that the purchaser knew of Henderson’s lack of authority. Accordingly, the partnership is bound.
Limited Partnership Act applies to the facts presented here:

A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.

The statutory language covers the facts stated. Lawler assumed a managerial role vis à vis the partnership and in the process became liable as a general partner.

C. Corporations

N84

Answer 5 (10 points)

a. Wonda is not liable to Servco on the preincorporation agreements. A preincorporation agreement made by a promoter does not bind the corporation even though it is made in the corporation's name. The corporation, prior to its formation, lacks the capacity to enter into contracts or to employ agents since it is nonexistent. Furthermore, unless after being formed the corporation adopts or knowingly accepts the benefits under the contract, it will not be held liable. Therefore, Wonda's express rejection of the preincorporation agreement will allow it to avoid liability.

Bold's liability to Servco depends on whether Bold clearly manifested his intent not to be personally bound on the preincorporation agreements. Such manifestation of intent can be shown by the express language or acts of the parties. The facts of the case at hand clearly show that Bold did not intend to be held personally liable on the agreements with Servco, since the contracts were executed in the name of Wonda, contingent upon adoption by Wonda, and were based solely on Wonda's anticipated credit. Therefore, Bold will not be held liable on the agreements with Servco.

Furthermore, a preincorporation agreement that is entered into by a promoter on behalf of a corporation to be formed and that is intended not to bind the promoter is not a contract but is merely a revocable offer to be communicated to the proposed corporation after its formation. Thus, under the facts, neither Bold nor Wonda will enjoy rights or suffer liabilities under the agreement.

b. Cash dividends may be declared and paid if the corporation is solvent and payment of the dividends would not render the corporation insolvent. Furthermore, each state imposes additional restrictions on what funds are legally available to pay dividends. One of the more restrictive tests adopted by many states permits the payment of dividends only out of unrestricted and unreserved earned surplus (retained earnings). The Model Business Corporation Act as recently amended prohibits distributions if, after giving effect to the distribution, the corporation's total assets would be less than the sum of its total liabilities.
c. The charge of negligence will fail if the directors can establish that they acted in good faith, in a manner reasonably believed to be in the best interests of the corporation and with such care as an ordinary prudent person in a like position would use under similar circumstances. Furthermore, under the business judgment rule, the court will not substitute its judgment for that of the board of directors as long as the directors acted in good faith and with due care.

The allegation that the directors failed to exercise due care by declaring cash dividends to shareholders that exceeded Wonda's profits and paid-in capital is without merit. Generally, if a director votes for or assents to the unlawful payment of dividends, that director will be jointly and severally liable along with all other directors so voting or assenting. However, directors will be relieved of liability if in voting or assenting to the payment of cash dividends they acted in good faith and in reliance upon information, opinions, reports, or statements prepared or presented by an officer or employee of the corporation whom the directors reasonably believe to be reliable and competent in the matters presented. Thus, the directors' reliance on the reports prepared and issued by Wonda's vice-president of finance was proper so long as the directors exercised due care, acted in good faith, and acted without knowledge that would cause reliance on the reports to be unwarranted. The reason for such a rule is to allow directors to use their best business judgment without incurring liability for honest mistakes.

N83
Answer 4  (10 points)

The action to compel reinstatement of prior dividends would fail. The declaration of dividends is a matter within the discretion of the board of directors. There are very few instances in which the board's discretion will be disturbed, and the facts of this problem are not within any of them unless Cox can prove the fraudulent purpose of the board, which she asserts.

The predominant rule gives a corporation the right to acquire its own shares. Such purchases may be made only to the extent of unreserved and unrestricted earned surplus. Capital surplus may be used only if the articles of incorporation so provide or if there is an affirmative majority vote by shareholders. The law and the facts indicate that in all probability there was no problem from the standpoint of the proper source of funds. With respect to the sale below par value there is no requirement to sell treasury shares at par value. The corporation laws require only that newly issued shares be sold at or above par value.

Cox's action to demand repayment of the salary increases would fail. The board of directors has broad discretionary power to fix salaries of officers, even if the officers also are members of the board. The courts have supported the board's determination of salary unless the amounts are grossly unreasonable. A 10 percent per year raise and the fact that the salaries are within the upper one-third of those paid by other similar corporations do not suggest salaries that would likely be found unreasonable and a waste of corporate assets.

Cox's action for dissolution would fail. The courts have power to dissolve a corporation in an action by a shareholder when the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock. To obtain a court-ordered dissolution Cox must also prove that irrepairable injury to the corporation is being suffered or is threatened. None of these facts are present. The fact that there is bitterness and animosity does not constitute a deadlock of the management. The corporation is continuing to increase its earnings at a 10 percent year rate. Courts are loath to grant an order for an involuntary dissolution even if there is a serious deadlock, provided the corporation continues to be a viable economic entity.

N82
Answer 3

Part a.

Yes. The shareholders will succeed. Directors and officers are fiduciaries and consequently must exercise the utmost good faith in respect of their corporation. If a "corporate opportunity" arises, they are required to offer the opportunity to the corporation. Generally a corporate opportunity will be found to exist if

- a director or officer becomes aware of the opportunity in his corporate capacity, or
- the opportunity relates to the business of the corporation.

The facts clearly indicate that such a corporate opportunity did exist, and thus the new yogurt opportunity should have been offered to Billings in the first instance. As a fiduciary, such an offer was necessary prior to exploitation of the opportunity by Harrelson. Moreover, Harrelson's use of corporate credit and personnel was a further violation of his fiduciary obligation. Accordingly, Billings' shareholders will prevail in their action. The remedy will include the holding of the Wexler stock in constructive trust for Billings, as well as possible damages against Harrelson for his personal use of corporate employees and credit.

D. Estates and Trusts

N83
Answer 5

Part b.

1. A trust must have a creator (settlor or grantor), trust property (principal, corpus or res), a trustee, and a beneficiary. There must be a writing if the subject matter of the trust is real property.
2. The Crawfords' trust was not created until December 1, 1982, when the land (the res) was conveyed to the trustee in writing. In the case of an inter vivos trust of real property with an independent trustee, the settlor (here the Crawfords) must go through whatever formalities (here a conveyance) are required to vest title in the trustee.

3. Yes. Although a trust having a duration of 10 years or more will qualify as a bona fide transferee of property for the purposes of shifting income to the trust or its beneficiaries, a transfer to a trust for a lesser duration will not qualify according to the Internal Revenue Code and Income Tax Regulations. This trust was intended to be what is popularly known as a "Clifford Trust."

4. No. State law precludes, except in rare circumstances, the termination of an irrevocable trust once created. Hence, the Crawfords are stuck with a useless trust for the balance of its term.

III. Contracts

**Answer 3 (10 points)**

Beach's minority at the time the contract with Reid was entered into will not be a valid defense. Despite Beach's misrepresentation of his age, the agreement with Reid was voidable at Beach's option while Beach was a minor. However, Beach's use and operation of the travel agency for at least seven months after reaching majority constituted an implied ratification of the contract. Some states may construe Beach's mere failure to disaffirm the contract within a reasonable time after reaching majority to be a ratification of the contract. Furthermore, a small number of states provide that minority is not a defense where the minor has entered into a business contract.

Beach's assertion that he is not liable due to Reid's violation of the contract clause prohibiting Reid from competing with Beach is correct because violation of the non-competition covenant is a material breach of the contract. Since the case at issue involves the sale of a business including its goodwill, the legal validity of a clause prohibiting competition by the seller is determined by its reasonableness regarding the time and geographic area covered. Each case must be considered on its own facts, with a determination of what is reasonable under the particular circumstances. It appears that, according to the facts of this case, the prohibition against Reid's operating a competing travel agency within a one mile radius of Beach's travel agency for two years is reasonable.

Abel's claim that he is not liable to Reid because of Beach's fraud in supplying him with false financial statements is incorrect. Although a creditor has a duty to disclose to the surety all material facts that would increase the surety's risk, the breach of such duty is not a valid defense of the surety if the creditor lacks knowledge of such facts. Therefore, unless Abel can show that Reid knew or had reason to know of the fraud committed by Beach, Abel will not be relieved of his surety undertaking.

Abel's claim that he is not liable to Reid because of Beach's minority is without merit. Beach's minority is a personal defense that in a proper case may be exercised only at Beach's option. Therefore, whether Beach has the power to disaffirm his contract with Reid will have no effect on Abel's surety obligations to Reid.

**Answer 3 (10 points)**

A corporate director's duty not to seize a corporate opportunity for himself is a duty owed to the corporation and may be enforced only by the corporation or its shareholders on its behalf. Breach of fiduciary duty by a director is not a valid defense in a contract action not involving the corporation.

Jones' assertion that Lark committed fraud will fail. Silence remains a viable defense to most claims of fraud. There are some instances where a duty to disclose is imposed, but these do not apply here. Nor is there any fiduciary or other obligation on Lark's part that would require disclosure to Jones.

The Statute of Frauds has been satisfied as there is a writing signed by the party to be charged (Jones). Jones' unexpressed subjective intent not to be bound is irrelevant. The validity of the option is to be determined on the basis of what a reasonably prudent offeree would conclude was objectively intended.
The contract involves the sale of real property. Hence the common law applies, not the Uniform Commercial Code. The common law does not recognize the validity of an option unless supported by consideration or unless there has been a statutory change making such an option valid without consideration. A limited number of jurisdictions have adopted such a rule, but it remains a distinct minority rule. Despite the clause in the option that stated Jones was to receive "$100 and other valid consideration," no consideration was actually paid. Although the courts are willing to accept a formalized bargain with the recital of the consideration contained in the contract as long as it is paid or performed, they are unwilling to accept a fictional bargain, i.e., one which is merely recited.

Lark would be entitled to the remedy of specific performance if the option contract were valid. Land is unique in the eyes of the law, and such a remedy has traditionally been available for the breach of such a contract.

In conclusion, the option is not binding upon Jones since it is not supported by the requisite legal consideration necessary to form a valid option contract.

Bar’s lawsuit against Cole will be based upon the intentional tort of wrongful interference with a contractual relationship. The primary requirement for this cause of action is a valid contractual relationship with which the defendant knowingly interferes. This requirement is met in the case of Cole. The contract is not required to be in writing since it is for exactly a year from the time of its making and is therefore valid even though oral. Cole’s knowledge of the contract is obvious. The principal problem, however, is damages. Since Bar was the first to successfully market the product, it would appear that damages are not present. It is possible there were actual damages incurred by Bar; for example, it hired another consulting firm at an increased price. It also might be possible that some courts would permit the recovery of punitive damages since this is an intentional tort.

Bar’s cause of action against Abel would be for breach of contract. Once again, damages would appear to be a serious problem. Furthermore, punitive damages would rarely be available in a contract action. Finally, Bar cannot recover the same damages twice. Hence, if it proceeds against Cole and recovers damages caused by Abel’s breach of contract, it will not be able to recover a second time.

Abel’s lawsuit against Cole will be based upon fraud and breach of contract. There were fraudulent statements made by Cole with the requisite intent and possibly to Abel’s detriment. The breach of contract by Cole is obvious. However, the contract that Cole induced Abel to enter into and which it subsequently breached was an illegal contract, that is, one calling for the commission of a tort. Therefore, both parties are likely to be treated as wrongdoers and Abel will be denied recovery.

M82
Answer 4 (10 points)

Part a.
1. Craig owes nothing beyond the terms of the original contract. The fact situation poses a classic example of a preexisting legal duty. The common law rule applicable to such situations is to deny recovery for any additional amount promised if the promisee does nothing more than he was obliged to do in any event. This resolution is arrived at by finding that there is no new consideration to support the modification of the original contract. It may be helpful to think in terms of two contracts, the original contract and the modification. The use of the identical consideration present in the first contract is not legal consideration for the second contract. Some jurisdictions have attempted to mitigate the harshness of this result either by statutory provision or by a strained judicial construction of the rule by the courts. The major change has occurred by the adoption of the Uniform Commercial Code throughout the United States, but the code applies only to contracts relating to personal property.

2. Yes. The drafters of Article 2 (Sales) of the Uniform Commercial Code considered the preexisting legal duty rule to be unreasonable when applied to commercial transactions involving the purchase or sale of goods. The rule had the effect of defeating the reasonable expectations of businessmen. Code section 2-209 rejects the preexisting legal duty rule by providing as follows: “An agreement modifying a contract within this article needs no consideration to be binding.” The code also provides that if the contract as modified is within the provision of the Statute of Frauds, the modification must be in writing. Since the modification needs no consideration and it is contained in a writing signed by the party to be charged, thus satisfying the Statute of Frauds, it is binding.

Part b.

Ogilvie’s first asserted defense is not valid. Although there was much in Ogilvie’s representations that was opinion and/or praise of the land, there were two statements of fact. One, that the land in question was virtually all splendid farmland and two, that it would be suitable for avocado growing. Neither turned out to be true. Thus, part of the first requirement for establishing fraud—a misstatement of fact—is present.

Second, Ogilvie’s misstatement of fact was material to the transaction—25 percent of the land is not usable for avocado growing and has only limited utility as farmland. A substantial decrease in utility and value must be categorized as material.
Third, Ogilvie's statement that he had not lied is no defense. Although he had some basis for making a statement about the quality of the land in general, he had no basis for making the statements he made. Even if he was not aware of the facts and cannot be said to have intentionally misstated the facts, he nevertheless manifested a reckless disregard for the truth. The scienter requirement was satisfied when he made positive statements of fact without any knowledge of their truth or falsity.

The final defense asserted is based upon the reliance requirement necessary to establish fraud. Ogilvie argued that Farber's failure to inspect the land when the opportunity was available results in a bar to recovery. However, although Farber's conduct may be categorized as negligent, such conduct does not normally allow the intentional tort-feasor to escape liability. Furthermore, to allow such a defense to prevail in general would have the potential of causing and fostering fraud, particularly on the unsophisticated investor.

IV. Debtor-Creditor Relationships

A. Suretyship

N83

Answer 3

Part b.

Grant is incorrect in his first three assertions and correct in connection with his fourth assertion for the following reasons:

- The law is clear regarding the right to collateral and its effect between the creditor and the surety. The creditor has the right to resort to any available collateral. Resort to the collateral by the creditor in no way affects the creditor's right to proceed against a surety or sureties for the balance.
- A creditor may choose to sue one or more of the sureties without impairing his rights against those not sued. Similarly, he has the right to sue one surety if he wishes, and such a choice does not release the surety who was not sued insofar as the rights of his fellow surety to seek contribution. Suing one but not all of the sureties does not constitute a release by the creditor.
- All of the defenses asserted in the fact situation are invalid. Grant is a cosurety since he is answering for the same debt as Victory, and there is a right of contribution which Victory may assert against Grant.
- Since Grant's surety undertaking was one-third of the combined surety undertakings, he is liable for $2,666.67 only and not the full $4,000.

B. Bankruptcy

N85

Answer 5  (10 points)

The trustee in bankruptcy may properly avoid or set aside the payment made by Baker to Nix on May 17 since it meets all the requirements necessary to establish a preferential transfer. In order to establish a preference, the trustee must show that the transfer

- Was to or for the benefit of a creditor.
- Was made for or on account of an antecedent debt owed by the debtor before such transfer was made.
- Was made while the debtor was insolvent.
- Was made within 90 days prior to the filing of the petition (when the creditor is not an insider).
- Enables the creditor to receive more than such creditor would receive in a liquidation proceeding.

There is a rebuttable presumption that the debtor is insolvent during the ninety days preceding the filing of the petition.

The transfer made by Baker to Wax on June 6 may not be avoided or set aside by the trustee. Since the transfer was intended by Baker and Wax to be a contemporaneous exchange for new value given to Baker and was in fact a substantially contemporaneous exchange, the trustee may not avoid the transfer of the mortgage to Wax.

The payment made by Baker on June 16 for the electric bill may not be avoided by the trustee since the debt was incurred and paid in the ordinary course of Baker's business, within forty-five days after the debt arose, and in accordance with ordinary business terms.

The trustee was correct by including in the estate rents and property received as a result of the final divorce decree. Generally, property acquired after the filing of a bankruptcy petition is not part of the debtor’s estate in bankruptcy but belongs to the debtor individually. However, there are certain exceptions to this rule. One such exception is rents earned on property of the debtor's estate. Thus, the rents received from July 1 through November 1 will be included in Baker's estate. Another such exception is property received by the debtor as a result of a final divorce decree within 180 days of the filing of the bankruptcy petition. Thus, the receipt of property by Baker on October 10 as a result of a final divorce decree falls within the 180 days after the filing of the bankruptcy petition on July 1 and is therefore included in the debtor’s estate.

B-95
Part a.

1. The principal avoiding powers of the trustee are
   • The power to set aside certain statutory liens.
   • The power to set aside preferential transfers.
   • The power to set aside fraudulent conveyances.
   • The power to set aside post-petition transfers.

2. The various claims and assertions would be resolved as follows:
   • The claim for an exemption allowance for the cottage will be disallowed. The Bankruptcy Code provides for one exemption for one’s principal residence, not to exceed $7,500. The home will qualify for this exemption.
   • There is no such rule applicable to business assets as contrasted with personal assets. In fact, there is no distinction between Skidmore and his business, Frock & Fashions. They are one and the same, and all assets will be collected and shared among the creditors without distinction of the source.
   • The Bankruptcy Code makes it clear that such conduct would not result in a denial of the discharge of the bankrupt. It will, however, result in the denial of that particular debt from discharge in bankruptcy. Thus, Walton’s claim will survive the bankruptcy proceeding.
   • A bona fide secured creditor is entitled to the collateral or its monetary equivalent. If this is insufficient to satisfy the loan, the secured creditor has the status of a general creditor for the balance. The priorities section of the Bankruptcy Code provides for no such priority as claimed by Harper.

Part a.

1. Under the Bankruptcy Reform Act of 1978, an involuntary petition may be filed by three or more creditors having claims aggregating $5,000 more than the value of any liens securing the claims. In the event there are fewer than 12 creditors, one or more creditors with claims of $5,000 or more can file. The facts indicate that Barry has $12,500 in overdue debts. It would appear likely that these requirements could be met and an involuntary petition could be validly filed. The act permits the involuntary debtor to file an answer to the petition.

2. No. Under the 1978 act, the principal defense available to an involuntary debtor would still be solvency. However, the defense of solvency in the bankruptcy sense (essentially a balance sheet approach) has been rejected when an involuntary liquidation is sought. Instead, the act has adopted a modified or expanded version of insolvency in the equity sense. A debtor is insolvent if he is generally not paying debts as they become due. In addition, a debtor is insolvent if within 120 days before the date of the filing of the petition a custodian was appointed or took possession of the debtor’s property. Barry, of course, appears to be squarely within the scope of the first part of this test. Realistically, he could not hope to have the petition dismissed on the grounds of solvency.

V. Government Regulation of Business

B. Federal Securities Acts

Part b.

West will prevail. The failure to include information concerning the unfavorable contracts is a violation of section 14(a) of the Securities Exchange Act of 1934, which applies to the proxy material of companies whose securities are traded on a national securities exchange.

A violation of section 14 gives rise to an implied right of action by aggrieved shareholders if the omitted or erroneous information is “material.” The Supreme Court has defined the word material as meaning “likely to affect the vote of a shareholder on the proposed action.” Here, the information is clearly material to the vote of the Jones shareholders.

The possible remedy for violation of section 14 is within the court’s discretion and includes damages or injunctive relief. In the case of a merger that has not been consummated, a court would likely set aside the vote and require resolicitation of the proxy material.
holders for any proper purpose. Proper purpose includes ousting the existing management. Since Powell owns 5 percent of the stock, it qualifies under this provision. If Baron refuses such access, Baron is liable to Powell for a penalty of 10 percent of the value of the stock held by Powell in addition to any other damages or remedy afforded by law.

2. Baron, having a class of securities regulated under the act, must either provide a list of shareholders or mail the proxy materials to the corporation’s shareholders. The expense of this mailing must be assumed by the insurgents.

3. Pursuant to the rules and regulations promulgated under section 14 of the Securities Exchange Act of 1934, the SEC has required that

- Proxy material must disclose all material facts on matters to be voted upon in order to enable shareholders to vote intelligently.
- Where control is at issue, names and interests of all participants must be disclosed.
- The proposed proxy material must be submitted for advance review by the SEC.
- Proxy materials must be distributed to the shareholders of record.

N82
Answer 2 (10 points)

The impact of the registration requirements of the Securities Act of 1933 on each of the proposals is as follows:

- The offering of the participation units in the citrus groves, although ostensibly the sale of an interest in land, constitutes an offer to sell, or the sale of, securities within the meaning of section 2 of the Securities Act of 1933. Although land itself is not a security, the offering of the land in conjunction with a management contract has been held to constitute the offering of a security. Since interstate commerce and communications are to be used and since there is no apparent transactional exemption available, a registration under the 1933 act is required. Whatever hope there was of an intrastate offering exclusion is dashed by the fact that the units will be offered and sold in two states.
- The short-term borrowings evidenced by the promissory notes of Various Enterprises are exempt from registration. This exemption from categorization as a security for purposes of registration under the act applies to commercial paper such as notes, drafts, checks, and similar paper arising out of a current transaction that have a maturity not exceeding nine months. In addition, the private placement exemption is applicable.
- If Various is deemed to be a controlling person insofar as Resistance is concerned, it must register the securities in question before it can legally sell them. The Securities Act of 1933 provides in connection with its definition of the term “underwriter,” that, “the term ‘issuer’ shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.”

Securities Act rule 405(f) further defines the term “control.” It states that “the term ‘control’ . . . means the possession, direct or indirect, of the power to direct or cause the direction of the policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” It is obvious that “control” as defined is a question of fact. In general, a controlling person has the power to influence the management and policies of the issuer. If an individual is an officer, director, or member of the executive committee, a low percentage of stock would suffice. Actual or practical control is sufficient and the power to exercise control will also be sufficient even if it is not exercised. Stock ownership is looked to and majority ownership naturally constitutes control. Although ownership of 17 percent of the stock is certainly not conclusive, it is a substantial block of stock and, if any of the above factors is also present, it would be most likely that Various would be a controlling person. Thus, although not the issuer of the stock, it would need to register the securities. This resembles a secondary offering of a large block by the owners of the corporation. This sale through the brokers will in no way insulate the transaction from registration.

N81
Answer 2 (10 points)

Part a.

1. The Securities and Exchange Commission has ruled that a merger such as this one constitutes a “sale.” Therefore, this merger must satisfy the requirements of the Securities Act of 1933. Accordingly, absent some possible exemption or exclusion, the securities must be registered and a prospectus must be distributed by Diversified to the Cardinal shareholders.

Also a possible danger, albeit a remote one, is that the merger may violate the provisions of section 7 of the Clayton Act. Although the two corporations do not compete and Cardinal is not a customer of Diversified’s, the act applies not only to vertical or horizontal mergers but also to conglomerate mergers such as this one. The Justice Department’s guidelines should be examined, and if there is any doubt about the validity of the acquisition from an antitrust standpoint, a ruling from the Justice Department should be sought.

2. Since this is to be a statutory merger pursuant to state law, the provisions of the appropriate statute, the Model Business Corporation Act, must be strictly complied with as well as any additional state law require-
ments. The steps to be followed by Diversified and Cardinal are as follows:

- The representatives of the two corporations must agree on a formal plan of merger. The plan containing the details of the merger must then be submitted to the board of directors in the form of a resolution and be approved by both boards.
- After approval of the plan of merger, the board, by resolution, directs that the plan be submitted to a vote at a meeting of shareholders.
- Due notice of the meeting, including a copy or summary of the plan, should be given to the shareholders. At each corporation’s meeting, a vote of the shareholders must be taken on the proposed plan. The plan or merger must be approved upon the affirmative vote of a majority of the shareholders of each corporation.
- Upon such approval by the respective shareholders, articles of merger are executed by the president or a vice president and the secretary of each corporation and then verified by one of the officers signing. The articles, along with the appropriate fees and taxes, must then be filed with the secretary of state, who will then issue a certificate of merger if the articles conform to law.
- Diversified need not amend its corporate charter to reflect the new class of preferred stock to be used in the merger. The act provides that, “In the case of a merger, the articles of the surviving corporation shall be deemed to be amended to the extent, if any, that changes in the articles of incorporation are stated in the plan of merger.”

Part b.

Yes. Problems are posed for Haskell Corporation because it is engaged in the offering and sale of its securities in interstate commerce. Therefore, under the Securities Act of 1933, it must file a registration statement, have it become effective, and supply a prospectus to the employees to whom stock is offered.

A claim of exemption as a private placement would fail for several reasons. First, among a great number of the employees, the quality of the investor’s financial knowledge would undoubtedly be quite low, and their employee relationship to Haskell would likely be such that they would not have access to the kind of information a registration would disclose. These are the very individuals that the act seeks to protect. Second, the number of individuals involved is so large that the offering cannot be considered nonpublic.

If Haskell does not comply with the registration and prospectus requirements, the SEC could obtain an injunction prohibiting such offers and sales. The possibility of damages is also present. In addition, purchasers of the Haskell stock could later seek rescission or damages based on noncompliance with the act’s requirements.

M81
Answer 4 (10 points)

Part a.

The legal implications of the conduct described can be best described as grave. Massive Manufacturing, Delwood, and its CEO, Feldspar, will all undoubtedly face criminal prosecution as a result of their conduct. Massive Manufacturing also has potential civil liability. The facts reveal clear-cut criminal violations of the Foreign Corrupt Practices Act of 1977.

The Foreign Corrupt Practices Act of 1977 prohibits payments to any foreign official or foreign political party or official thereof to influence the act or decision of that person or party acting in an official capacity. Any issuer convicted of engaging in such illegal conduct is subject to fines not exceeding $1 million. The act also requires that adequate accounting books and records must be maintained. This broad and somewhat nebulous provision applies to any securities issuer that is subject to registration under section 12 of the Securities Exchange Act of 1934 and that must file reports thereunder. This provision applies to Massive in that its stock is listed on a national exchange. Massive has obviously violated the part of the act stating that an issuer must “make and keep books, records and accounts which in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer.” This separate violation is subject to the omnibus criminal and civil sanctions applicable to activities proscribed by the Securities Exchange Act of 1934.

Feldspar and Delwood, acting in their capacities as officers, agents, and/or directors of Massive, are personally subject to the provisions of the Foreign Corrupt Practices Act. If they are convicted of willfully violating the act, each is subject to a fine of not more than $10,000 or to imprisonment for not more than five years or both.

In addition the SEC may take administrative action against Massive by seeking injunctive relief, which could result in the suspension of trading of Massive’s shares.

Part b.

1. The Securities Act of 1933 exempts from registration “any security which is part of an issue offered and sold only to persons resident within a single state . . . where the issuer of such security is a corporation incorporated by and doing business within such state.” If an offering otherwise qualifies for this exemption, the use of the facilities of interstate commerce is permitted. According to the facts, Marigold could qualify for the intrastate exemption.

However, very strict requirements apply to the offerees and purchasers: They must all be “residents” of the single state in question. Consequently, an offer to one nonresident can nullify the entire exemption. Meticulous care must be taken to ensure that no offers or
sales are made to nonresidents, which, from a practical standpoint, may be extremely difficult to ascertain. A further limitation applies to issuers. Since the underlying rationale of the exemption as articulated by the SEC is "to provide for local financing for local industries carried out through local investment," the judicial and administrative interpretations of "doing business" have been strict. Essentially, the SEC has ruled that an issuer is doing business within the state if it derives 80 percent of its revenues from the state, has 80 percent of its assets within the state, intends to use 80 percent of the proceeds from the offering within the state, and has its principal office within the state.

If the above requirements and limitations are not enough, an added requirement regarding resale of the distributed securities must be satisfied. In effect, there must not be a resale of the securities to nonresidents for a period of nine months.

2. Even if an exemption to federal registration is available, state law must be complied with. State securities laws popularly known as "blue sky" laws are not entirely uniform; however, at least a minimum filing generally will be required as well as a clearance to offer and sell the securities within the state.

VI. Uniform Commercial Code

A. Commercial Paper

N83
Answer 2

Part b.

1. The instrument in question is a draft and is commonly known as a trade acceptance. Such an instrument arises out of a sales transaction, whereby the seller is authorized to draw upon the purchaser for payment of the goods. Normally, as is the case here, the seller is both the drawer and the payee. The instrument is then presented for the buyer's acceptance.

2. No. The instrument lacks the "magic" words of negotiability on its face. That is, it is not payable to order or bearer but instead payable solely to Hardy & Company. The endorsement on the back of the instrument neither cures the defect nor provides the requisite words of negotiability. Hence, the instrument is not negotiable. The "for value received..." does not in any way affect negotiability.

3. No. Melba would be a holder in due course. He took in good faith and gave value even though the value in question is an antecedent indebtedness. The Uniform Commercial Code specifically provides that an antecedent indebtedness is value. Therefore, Melba as a holder in due course takes free of the so-called personal defenses. Breach of warranty and contractual defenses are personal defenses and a holder in due course such as Melba is not subject to them.

M83
Answer 5

Part a.

1. Pine is not a holder in due course because he has knowledge of a defense against the note. However, Pine has the rights of a holder in due course because he acquired the note through Gordon, who was a holder in due course. The rule wherein a transferee, not a holder in due course, acquires the rights of one by taking from a holder in due course is known as the "shelter rule." Through these rights, Pine is entitled to recover the proceeds of the note from Beeler. The defense of fraud in the inducement is a personal defense and not valid against a holder in due course or one with the rights of a holder in due course.

2. As one with the rights of a holder in due course, Pine is entitled to proceed against any person whose signature appears on the note, provided he gives notice of dishonor. When Dunhill negotiated the note to Gordon, Dunhill's signature on the note made him secondarily liable. As a result, if Pine brings suit against Dunhill, Pine would prevail because of Dunhill's secondary liability.

M81
Answer 2 (10 points)

Part a.

Harrison will prevail, but only to the extent of "value," here $8,500, given for the negotiable promissory note. The primary issue in the case is the "value" requirement for holding in due course. The facts reveal that Harrison purchased the instrument in good faith, that it was not overdue, and, at the time the negotiation took place, Harrison had no knowledge of the fraudulent circumstances under which the instrument was originally obtained from Oliver. The facts indicate that the note was negotiable and that the negotiation requirement was satisfied.

The Uniform Commercial Code section dealing with "taking for value" provides that a holder, here Harrison, takes for value to the extent that the agreed consideration has been performed. Certainly, the payment of the $5,000 in cash constitutes value. The code...
further provides that when a holder gives a negotiable instrument for the instrument received, he has given value. Although this provision is primarily concerned with the giving of one's own negotiable instrument, it is obvious that the negotiation of another's negotiable instrument as payment is value. However, the promise to pay an agreed consideration is not value even though it constitutes consideration.

Part b.

1. No. Williams will not prevail. The Uniform Commercial Code imposes upon the depositor the responsibility for reasonable care and promptness in discovering and reporting this unauthorized signature. In any case, the depositor must discover and report his unauthorized signature within one year from the time the items (checks) are made available to him. The latter rule applies irrespective of lack of care on the part of either the bank or depositor. This absolute rule is based in part upon the rationale that, after certain periods of time have elapsed in respect to commercial transactions, finality is the most important factor to be considered. Thus, after this amount of time has elapsed, existing expectations and relations are not to be altered.

2. No. The bank cannot collect from McCarthy. The Uniform Commercial Code places the burden upon the bank to know at its peril the signature of its drawer. Therefore, when the bank has paid on the forged signature of a depositor, it cannot recover the loss by seeking collection from a party who has received payment in good faith.

3. The first answer (b.l.) would be changed in that the law allows the depositor a three-year period in which to discover the forged signature of the payee or an indorser. Thus, if both the bank and depositor are not negligent (as it would appear from the excellence of the forgery), the loss rests with the bank. However, if it can be shown that the depositor was negligent (for example, he disregarded a notice from the proper party that he had not received payment), the bank will prevail if it was in no way negligent.

The restated circumstances also change the second answer (b.2.). A bank is not deemed to know the signatures of indorsers; therefore, the bank may recover its loss from McCarthy, the party collecting on the item. Section 3-417 of the Uniform Commercial Code provides that a party receiving payment on the instrument warrants to the payor that he has good title to the instrument.

C. Sales

M85

Answer 2 (10 points)

a. The sale of leather jackets is governed by the Uniform Commercial Code Sales Article which applies to transactions in goods. Under the Uniform Commercial Code, an oral contract for the sale of goods under $500 does not fall within the provisions of the statute of frauds. Thus, the contract between Reed and Rocco is enforceable by either party without the necessity of a signed writing since the sales price is $450. The UCC provides that an agreement to modify a contract for the sale of goods needs no consideration to be binding. However, the modification made must meet the test of good faith. The modification must also satisfy the requirements of the statute of frauds if the contract, as modified, falls within its provisions. Whether Reed acted in good faith is determined by an examination of the facts. Here, the shift in the market may satisfy the requirement of good faith if Reed can show that he had suffered a loss had he sold the jackets at $450. However, if Reed refused to sell the jackets at $450 merely to derive a greater profit, with knowledge that Rocco was in immediate need of the goods, the modification may not meet the test of good faith.

Since the sales price increased from $450 to $550, the contract must satisfy the statute of frauds in order to be enforceable. The UCC statute of frauds may be satisfied by a confirmation if

• Both parties are merchants.
• It is in writing.
• The writing is signed by the sender.
• The writing states the quantity.
• The writing is received by the recipient within a reasonable time.
• The recipient has reason to know the contents of the writing.
• The recipient fails to give written notice of objection to its contents within ten days after receipt.

As the facts clearly indicate, the mailing of the signed letter by Reed to Rocco the day after the contract was orally modified, coupled with Rocco's failure to object within ten days after receipt will satisfy the requirements of the statute of frauds.

b. No. As a general rule, a contract for the sale of real property must be supported by a written memo signed by the party to be charged. However, an oral contract to sell real property may be removed from the statute of frauds where there has been part performance and reasonable reliance on the oral contract. The part payment of the sales price by Reed, in addition to Reed's taking possession of the building with Smith's consent and making permanent and substantial improvements, generally will prevent Smith from setting the contract aside or requiring Reed to vacate the building.

M83

Answer 5

Part b.

1. Although the parties involved are permitted to allocate risk of loss in any manner they deem appropriate, assuming that there was no provision in the agreement
regarding risk of loss, the Uniform Commercial Code sets forth very specific rules which depart sharply from the common law concept dependent upon whether title had been transferred. Sales contracts that require the seller to ship the goods F.O.B. seller's location are known as "shipment" contracts, while contracts requiring the seller to deliver to a particular destination are known as "destination" contracts.

The first set of tools was sold under "destination" terms which means that risk of loss passed to Dennison only when the goods arrived at that destination and were duly tendered to enable Dennison to take delivery. Thus, Elba would bear the risk of loss.

Regarding the second set, which entailed "shipment" terms, risk of loss passed when the goods were properly delivered to the carrier. Thus, although the property was destroyed prior to delivery, risk of loss had already passed to Dennison.

2. Drew. The UCC sets forth specific provisions regarding the effects of breach (both by the seller and buyer) on risk of loss. Assuming a seller's breach, as is the case here, the code provides that where a tender or delivery of goods so fails to conform to the contract as to give a right of rejection, the risk of loss remains on the seller until cure or acceptance.

M82
Answer 5 (10 points)

Part a.

No. The fading was certainly not an "Act of God," nor was it to be expected. An implied warranty regarding fitness would have existed were it not for the disclaimer. The disclaimer coupled with the parol evidence rule will prevent recovery by the purchaser for breach of warranty.

The facts pose an interesting problem whether either of the implied warranties apply. Courts might differ on whether fading would prevent the goods from being merchantable or fit for the purpose for which they were purchased. However, assuming such implied warranties do exist, they will not survive the combination of the disclaimers in conjunction with the parol evidence rule.

The parol evidence rule negates any showing of an additional express warranty, oral or written, not embodied in the contract. The language of the contract, in fact, deliberately incorporates the rule. The language is clear; it states that no additional warranty protection is afforded the buyer unless incorporated into the contract. The fourth and fifth provisions of the contract eliminate the quality warranties of merchantability and fitness and do so in the manner prescribed by section 2-316 of the Uniform Commercial Code.

Part b.

1. Yes. Wilmot's asserted legal defenses are without merit. Recovery by Nielsen will be limited to 20 cents per pair, which is the difference between the contract price and the additional amount that it would have cost to purchase the goods elsewhere at the time the buyer learned of the breach. When the notice of cancellation was received, the contract price was $2.50 and the market price was $2.70.

2. No. Specific performance would not be available under the circumstances. Money damages are adequate in that it would be compensated for the amount it would have to pay to buy the goods elsewhere. Hence, it would be in as good a position as it would have been otherwise.

3. No. The Uniform Commercial Code covers these points specifically. If a seller discovers after the making of the contract, but prior to the delivery of the goods, that his customer is insolvent, he still cannot terminate the contract. However, Wilmot has the right to refuse delivery except for cash payment.

N81
Answer 5

Part b.

Maxwell will prevail. As a result of advertising placed in the window and at the display counter, she may rely upon an express warranty of fitness of the radio's capability of receiving adequate reception of radio broadcasts. This would be characterized as a written express warranty, as many recent cases have held written advertising statements about the product in question to be. Next, Maxwell could claim that an oral express warranty was given by Golden, although this would appear to be a rather weak argument in regard to both the facts and the law. Maxwell's recovery also can be based upon the implied warranty protection of the Uniform Commercial Code. First, she could assert that a shortwave radio intended to receive transmissions from throughout the world was not of merchantable quality (fair and average) if it was incapable of receiving clear transmissions from the Soviet Union. Although this may be a plausible argument, it is obvious that the implied warranty of fitness for the purpose indicated is a better theory upon which to proceed. She clearly made her needs of purposes known to Golden, who nodded and smiled in apparent agreement. Thus, Maxwell has a wide variety of warranties to which she may resort in seeking recovery.

There are two arguments that Ultraclear would make in defense and that are alluded to in the final paragraph of the facts. First, they made no warranty as a result of the advertising. This they would claim to be merely either opinion or puffing. They would couple this with the fact that they didn't use the term warrant or guarantee. However, the UCC does not require the use of such words to create a warranty, and the statement "Listen to Radio Moscow" is a statement of fact or promise and not mere puffing or opinion.

Next, Ultraclear would rely upon its oral disclaimer as a defense. Although Ultraclear purported to ne-
gate any implied warranty protection, this argument would fail because it is inapplicable insofar as the express warranties discussed above are concerned. The oral disclaimer is also ineffective with respect to the implied warranty of merchantability, since the code requires that any such disclaimer specifically mention the word merchantability. To exclude the warranty of fitness, the code also requires that the exclusion be in writing and be conspicuous.

Since there are several warranties that have been made or implied and that have been breached by Ultraclear, and, since its defenses will be of no avail, Maxwell should win her case for rescission.

D. Secured Transactions

Answer 4 (10 points)

a. Yes. In order for a security interest in collateral to attach, the following three requirements must be met: 1. The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement that contains a description of the collateral; 2. value has been given by the secured party; and 3. the debtor has rights in the collateral.

Zen, under the stated facts has fulfilled all three requirements, thereby creating an enforceable security interest that has attached to the computer. Since the transaction involves a purchase money security interest in consumer goods—that is, goods used or bought primarily for personal, family, or household purposes—it is not necessary for the secured party to file a financing statement or take possession of the collateral in order to perfect its interest. The security interest is perfected when the three requirements set forth have been fulfilled.

b. Yes. Generally, a secured party with a perfected security interest has priority over all subsequent claims to the same collateral. However, in the case of consumer goods, where perfection is achieved solely by attachment, a subsequent buyer will take free of such prior perfected security interests if he buys without knowledge of the security interest, for value, for his own personal, family, or household use and before a financing statement is filed by the secured party. Since Ralph has complied with those qualifications, he will take the computer free of Zen’s perfected security interest.

c. Ned. The UCC sales provisions state that any entrusting of possession of goods to a merchant who deals in goods of that kind gives such merchant the power to transfer all rights of the entruster to a buyer in the ordinary course of business. Furthermore, the entruster, in delivering and acquiescing in the merchant’s retention of possession of the goods, must be the rightful owner in order for the merchant to acquire the power to transfer complete ownership and title. Since Sauer’s delivery of the stereo to Zen constituted an entrusting, Zen acquired the power to transfer title and ownership to Ned. Thus, upon Ned’s purchase of the stereo in good faith and without knowledge of Sauer’s true ownership interests, Ned acquired title to the stereo.

Answer 2

Part a.

- Zeals has priority over Despard regarding the competing security interests of the parties. Zeals is a purchase money secured party involving the sale of consumer goods. As such, the security interest is enforceable against other creditors of the buyer without the necessity of a filing. Despard would also attempt to assert a purchase money security interest in the goods, but this is questionable at best since the money advanced was obviously not used for the purchase of the goods. Even if Despard qualified as a purchase money secured party, Despard was second in point of time. The fact that it filed does not change the priority, since filing was not required to perfect the interest in the consumer goods (the video system).

- Apache has priority over Despard in this instance. Although Despard was the first to advance credit and qualified as a purchase money lender, it was second in time to perfect its security interest. The subject matter of the sale was equipment, and filing is required to perfect Despard’s security interest. The purchase money lender has the benefit of a 10-day grace period for filing. Despard’s security interest was not perfected until it filed, which was after the grace period and five days after Apache’s filing.

Answer 3 (10 points)

Part a.

1. In order to prevail against the creditors of a party to whom goods have been consigned, the consignor may do one of three things according to the Uniform Commercial Code (section 2-326):

a. Comply with applicable state law providing for a consignor’s interest to be evidenced by a posted sign. Most states do not have such statutes.

b. Establish that the person conducting the business is generally known by his creditors to be substantially engaged in selling the goods of others. This is either not the case or is difficult to prove.

c. Comply with the filing provisions of Article 9: Secured Transactions. From a practical standpoint, this last course of action appears to be the most logical, if not the only, choice.

Article 9 (section 9-114) requires that a consignor comply with the general filing requirements of the code (section 9-302) and also give notice in writing to the
creditors of the consignee who have a perfected security interest covering the same type of goods. The written notice must be given before the date of filing by the consignor and received within five years before the consignee takes possession of the goods. The notice must state that the consignor expects to deliver goods on consignment to the consignee and must contain a description of the goods.

2. No. Walpole will not prevail. Whether a consignment is a “true” consignment (an agency relationship) or is intended as a security interest, the Uniform Commercial Code requires that notice be given to creditors of the consignee.

A consignment is governed by sections from two articles of the code: Article 2: Sales and Article 9: Secured Transactions. Section 2-326 treats a consignment as a “sale or return” because “the goods are delivered primarily for resale.” Section 2-326(3) provides the following:

Where goods are delivered to a person for sale and such person maintains a place of business at which he deals in goods of the kind involved, under a name other than the name of the person making delivery, then with respect to claims of creditors of the person conducting the business the goods are deemed to be on sale or return. The provisions of this subsection are applicable even though an agreement purports to reserve title to the person making delivery until payment or resale or uses such words as “on consignment” or “on memorandum.”

It is obvious from the facts, that Walpole’s marketing arrangement is covered by the above language. The code further provides that the creditors of the consignee will be able to assert claims against goods sold on a sale or return basis unless some form of notice is given.

Part b.

Lebow will prevail to the extent of the 65 percent of the bolts of wool that it repossessed on August 11, 1980. Since Lebow obtained possession of 65 percent of the shipment prior to attachment or judgment by Dunbar, Lebow’s security interest with respect to those goods had been perfected as of August 11. The original erroneous filing is invalid against the creditors of Fashion Plate. Lebow’s security interest was not perfected by filing initially, and, therefore, Lebow will not prevail over the rights of Dunbar, a subsequent lien creditor of Fashion Plate. The facts of the case indicate that the security interest was not perfected by filing until August 20, 1980. However, prior to that time Dunbar levied against the goods on August 13 and obtained a judgment against Fashion Plate on August 18, 1980. Both dates are prior to the August 20 filing by Lebow; thus, the lien creditor would have priority over Lebow’s claim based exclusively on perfection by filing. Perfection can also be accomplished by possession, but if perfection by either method precedes the time that the lien creditor obtains rights against the property, it prevails.

VII. Property

A. Real and Personal Property

M84

Answer 4 (10 points)

1. The trust will have no interest in Redacre but would have a one-quarter interest as tenant in common in Bigacre. The attempted transfer of realty held as tenants by the entirety without the co-owner’s consent does not transfer the property. Therefore, Ted is unable to transfer any portion of Redacre since Judy has not consented to the transfer. A joint tenant may transfer his interest in the tenancy without the consent of the cotenants. However, such a transfer destroys the joint tenancy of the interest transferred. Therefore, the purchase of Ted’s interest in Bigacre gives the trust a one-quarter interest in the property as tenant in common with Clark, Lois, and Jeff remaining as joint tenants of three-quarters of the property.

2. Despite the trust’s one-quarter interest in Bigacre, it acquires no additional interest due to Clark’s death, since there is no right of survivorship with respect to a tenant in common. However, Jeff and Lois will acquire Clark’s one-quarter interest by operation of law, due to the right-of-survivorship feature among joint tenants. Therefore, Jeff and Lois will each own a three-eighths interest in Bigacre as joint tenants, whereas the trust will retain its one-quarter interest as a tenant in common.

3. A valid trust has been created. Ted, as grantor or settlor, has transferred property (res) to Guardem and Peter for the benefit of Peter. Intent to create a trust is evident, and the trust is established for a lawful purpose. It is proper for the sole beneficiary to act as cotrustee.

4. The trustees have a fiduciary duty to manage the trust for the benefit of the beneficiaries. In the absence of trust provisions otherwise, the trustees are required to invest in accordance with the standard of a prudent man in the conduct of his own investments. A trustee should ordinarily invest in income-producing property.
However, the purchase of Bigacre by the trustees could meet this standard even though Bigacre is not currently earning income if the amount paid is fair and the future value may be expected to increase.

5. The trust would terminate and the interest in Bigacre would vest in Peter if he exercises his right to remove Guardem as trustee. As sole trustee Peter would hold legal title, and as sole beneficiary he would hold equitable title. A trust terminates when the sole beneficiary and sole trustee are the same person as legal and equitable title will be merged.

N82
Answer 5

Part b.

Based upon the facts of the problem and the legal criteria discussed below, it appears that the manufacturing machinery retains its character as personality and therefore can be removed by Darby at the expiration of the building lease and is properly being depreciated over its estimated useful life of thirty years. The central air conditioning system, however, appears to be realty and therefore cannot be removed by Darby at the expiration of the building lease. It should therefore be depreciated by Darby over the term of the lease, that is, twenty years.

In order to determine the rightful ownership of the central air conditioning system and the manufacturing machinery upon expiration of the building lease, one needs to determine if either or both should be regarded as realty by virtue of being fixtures. Whether a particular item of personality becomes a fixture depends on whether there has been an annexation to the realty and an intention that the item become a fixture. The intention is inferred from such matters as (1) the nature of the item, (2) the manner of its attachment to the realty, and (3) the possible injury to the realty that might be caused by its removal.

In Darby's case, both the central air conditioning system and the machinery would likely be fixtures under this analysis. However, when personal property is attached to realty for the particular purpose of increasing the business profits of a tenant during a lease term, such personal property is ordinarily classified as a trade fixture. The manufacturing machinery clearly fits into this category, since it is directly used to increase Darby's business profits. A trade fixture may be removed by the lessee unless it is so built into the realty that it becomes an integral part thereof. Accordingly, if it can be removed at the building's lease term with no material damage to the building, it may be removed.

It is unlikely that the central air conditioning system would be considered to be a trade fixture. Thus, it is subject to the general rules applicable to fixtures discussed above. As a result, it has become realty and cannot be removed at the end of the lease.

B. Mortgages

N84
Answer 2 (10 points)

a. If Bean purchases the plant subject to the mortgage, Fine will remain liable to Muni on the note and the underlying mortgage. Thus, Fine will be liable to Muni for any deficiency that may exist after a foreclosure sale. By taking the plant subject to the mortgage, Bean avoids liability for any deficiency. Therefore, Bean's potential liability is limited to any equity he may have built up in the plant.

If Bean assumes the mortgage, Fine will continue to be liable to Muni despite the agreement permitting Bean to assume the mortgage. Therefore, any resulting deficiency from a foreclosure sale will be Fine's responsibility. In addition, since Bean assumed the mortgage, he would also be held liable to Muni.

The execution of a novation would release Fine from his liability to Muni on the mortgage and would substitute Bean in his place. In order to have a valid novation involving real property, Muni must agree to it in writing.

b. Fine is incorrect in his assertion that the clause prohibiting the assignment of the lease is void. A clause prohibiting the assignment of a lease will not constitute a disabling restraint sufficient to prevent the free alienation of property and is therefore valid. Fine is bound by the restrictive clause since he consented to it when entering into the lease.

Fine's assertion that the prohibition against assignment will not affect his right to sublease is correct. In the absence of a provision in the lease to the contrary, a tenant has the right to assign the lease or sublet the premises. A prohibition against either will not be a prohibition against both. Therefore, Fine may sublease the warehouse to Bean despite the clause forbidding the assignment of the lease.

Fine's assertion that he will be released from liability under the lease upon obtaining Jay's consent to either sublet or assign is incorrect. Under a sublease or assignment, the original tenant will remain fully liable for the stipulated rent unless the landlord releases the original tenant from that obligation. The fact that the landlord consents to the sublease or assignment will not automatically relieve the original tenant from his obligation to pay rent. Therefore, any rent due pursuant to the lease will continue to be Fine's legal responsibility.

N81
Answer 4

Part b.

Adventure Mortgage Company is correct in its assertion. Adventure had no actual or constructive notice of
Unofficial Answers

the fraud. It has a valid second mortgage that was properly filed and recorded prior to the closing. Vance Manufacturing, Inc., had constructive notice of the mortgage as a result of the filing and took title to the property subject to the Adventure mortgage. Vance must either pay Adventure or be subject to a foreclosure action.

Although Vance stands to lose $10,000 with respect to Adventure's claim, it is likely that Vance can recover the loss from its attorney, based on an action for negligence. The attorney's final examination of the title prior to closing was clearly inadequate. It was made at a time that was too far in advance of the closing to provide the protection needed. Final examination of title is generally made immediately prior to closing.

Of course, Vance would have a cause of action against Lauer based on deceit (fraud), although recovery seems unlikely. Vance's attorney, assuming he is liable as a result of a finding that he was negligent, would be subrogated to the rights of his client and entitled to recover from Lauer for deceit.

C. Fire and Casualty Insurance

N82
Answer 5

Part a.

1. The recoverable loss is determined by reference to the following formula:

\[
\frac{\text{Insurance carried}}{\text{Insurance required}} \times \text{the amount of the loss}
\]

where the insurance required is defined as the value of the property at the time of the loss multiplied by the coinsurance percentage. Applying the foregoing formula, the amount of the loss recovered is as follows:

\[
\frac{\$600,000}{\$1,000,000 \times .8} \times \$200,000 = \$150,000.
\]

2. The $150,000 will be distributed as follows: $106,000 to Second National and $44,000 to Jackson. This is because Second National's insurable interest equals the extent of its mortgage outstanding, which is limited to debt outstanding plus accrued interest, and is paid first. The remaining $44,000 would then be paid to Jackson.

3. Jackson will recover $300,000—the face amount of the policy. The coinsurance clause does not apply to a total loss.

4. Jackson will recover $45,000. The formula for determination of the total amount recoverable under the 80% coinsurance clause is as follows:

\[
\frac{\$150,000}{\$250,000 \times .8} \times \$60,000 = \$45,000.
\]

5. Jackson will recover $30,000 from Queen. This amount is determined as follows:

\[
\frac{\$100,000 \text{ (Queen's coverage)}}{\$150,000 \text{ (Total coverage)}} \times \$45,000 = \$30,000.
\]
EXAMINATION IN BUSINESS LAW
(Commercial Law)

November 8, 1985; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

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INSTRUCTIONS TO CANDIDATES
(Disregard of these instructions may be considered as indicating inefficiency in accounting work.)

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since 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.

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

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.
Uniform Certified Public Accountant Examination

Number 1 (Estimated time — 110 to 130 minutes)

Instructions

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

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

Item

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

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

Bridge Builders intended to create a (an)

a. Option contract.
b. Unilateral contract.
c. Bilateral contract.
d. Joint contract.

Answer Sheet

99. (a) (b) (c) (d)

Items to be Answered

1. Which of the following is a characteristic of an unincorporated association?

a. It may only be used for not-for-profit purposes.
b. Members who actively manage the association may be held personally liable for contracts they enter into on behalf of the association.
c. Certificates representing ownership in the association must be distributed to the members.
d. Its duration must be for a limited period of time not to exceed 12 months.

2. Orr Corp. declared a 7% stock dividend on its common stock. The dividend

a. Is includable in the gross income of the recipient taxpayers in the year of receipt.
b. Must be registered with the SEC pursuant to the Securities Act of 1933.
c. Requires a vote of the shareholders of Orr.
d. Has no effect on the earnings and profits for federal income tax purposes.

Items 3 and 4 are based on the following information:

Jane Cox, a shareholder of Mix Corp., has properly commenced a derivative action against Mix's Board of Directors. Cox alleges that the Board breached its fiduciary duty and was negligent by failing to independently verify the financial statements prepared by management upon which Smart & Co., CPAs, issued an unqualified opinion. The financial statements contained inaccurate information which the Board relied upon in committing large sums of money to capital expansion. This resulted in Mix having to borrow money at extremely high interest rates to meet current cash needs. Within a short period of time, the price of Mix Corp. stock declined drastically.

3. Which of the following statements is correct?

a. The Board is strictly liable, regardless of fault, since it owes a fiduciary duty to both the corporation and the shareholders.
b. The Board is liable since any negligence of Smart is automatically imputed to the Board.
c. The Board may avoid liability if it acted in good faith and in a reasonable manner.
d. The Board may avoid liability in all cases where it can show that it lacked scienter.

4. If the court determines that the Board was negligent and the Board seeks indemnification for its legal fees from Mix, which of the following statements is correct?

a. The Board may not be indemnified since a presumption that the Board failed to act in good faith arises from the judgment.
b. The Board may not be indemnified unless Mix's shareholders approve such indemnification.
c. The Board may be indemnified by Mix only if Mix provides liability insurance for its officers and directors.
d. The Board may be indemnified by Mix only if the court deems it proper.

5. Rice is a promoter of a corporation to be known as Dex Corp. On January 1, 1985, Rice signed a nine-month contract with Roe, a CPA, which provided that Roe would perform certain accounting services for Dex. Rice did not disclose to Roe that Dex had not been formed. Prior to the incorporation of Dex on February 1, 1985, Roe rendered accounting services pursuant to the contract. After rendering accounting services for an additional period of six months pursuant to the contract, Roe was discharged without cause by the board of directors of Dex. In the absence of any agreements to the contrary, who will be liable to Roe for breach of contract?

a. Both Rice and Dex.
b. Rice only.
c. Dex only.
d. Neither Rice nor Dex.
6. On May 1, Apple mailed a signed offer to sell an office building to Fein for $90,000. The offer indicated that it would remain open until May 10. On May 5, Fein assigned the offer to Boyd for $5,000. On May 8, Boyd orally accepted Apple’s offer. Apple refused to sell the building to Boyd. Which of the following statements is correct?
   a. Fein’s assignment to Boyd was effective because an option contract was formed between Apple and Fein on May 1.
   b. Fein’s assignment to Boyd was effective against Apple because valid consideration was given.
   c. Boyd’s acceptance was ineffective because the offer could not be assigned.
   d. Boyd’s acceptance was ineffective against Apple because it was oral.

7. Fenster Corp. requested Wein & Co., CPAs, to perform accounting services for it. Wein agreed to perform the services. Fenster and Wein had not discussed the amount of the fees. Which of the following is correct?
   a. No contract was formed since the amount of the fees was not agreed upon.
   b. A quasi contract was formed at the time Wein agreed to perform the services.
   c. A unilateral contract was formed at the time of Fenster’s request.
   d. A bilateral contract was formed at the time of Wein’s agreement to perform.

8. 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 sufficiently definite and certain.
   b. Manifest an intent to enter into a contract.
   c. Be communicated by words to the offeree by the offeror.
   d. Be communicated to the offeree and the communication must be made or authorized by the offeror.

9. The statute of frauds
   a. Requires the formalization of a contract in a single writing.
   b. Applies to all contracts having a consideration valued at $500 or more.
   c. Applies to the sale of real estate but not to any leases.
   d. Does not require that the contract be signed by all parties.

10. One of the elements necessary to establish fraud is that
   a. There was a written misrepresentation of fact.
   b. The defendant was in a position of trust and confidence with respect to the plaintiff.
   c. The defendant made a false statement with actual or constructive knowledge of its falsity.
   d. The plaintiff was induced to enter into a contract as the result of an improper threat by the defendant.

11. On April 1, Knox signed and mailed a letter containing an offer to sell Wax a warehouse for $75,000. The letter also indicated that the offer would expire on May 3. Which of the following is correct?
   a. The offer is a firm offer under the UCC and can not be withdrawn by Knox prior to May 3.
   b. Wax can benefit from the early acceptance rule no matter what means of communication he uses as long as the acceptance is sent on or before May 3.
   c. If Wax purports to accept the offer on April 15 at $50,000 and Knox refuses to sell at that price, Wax nevertheless has the right to accept at $75,000 by May 3.
   d. A telephone call by Wax to Knox on May 3, accepting the offer at $75,000, will effectively bind Knox.

12. Ted King, a building subcontractor, submitted a bid for construction of a portion of a high-rise office building. The bid contained material errors in computation. Lago Corp., the general contractor, accepted the bid with knowledge of King’s errors. King
   a. Must perform the contract unless he can show that Lago acted fraudulently.
   b. Must perform the contract according to the stated terms since his errors were unilateral.
   c. Will avoid liability on the contract only if his errors were not due to his negligence.
   d. Will avoid liability on the contract since Lago knew of King’s errors.

13. In determining whether the consideration requirement has been satisfied to form a contract, the courts will be required to decide whether the consideration
   a. Was bargained for.
   b. Was fair and adequate.
   c. Has sufficient economic value.
   d. Conforms to the subjective intent of the parties.

14. Ruehl purchased a service station business from Lull. The purchase price included payment for Lull’s goodwill. The agreement contained a covenant prohibiting Lull from competing with Ruehl in the service station business. Which of the following statements regarding the covenant is incorrect?
   a. The value to be assigned to it is the excess of the price paid over the seller’s cost of all tangible assets.
   b. The time period for which it is to be effective must be reasonable.
   c. The restraint must be no more extensive than is reasonably necessary to protect the goodwill purchased by Ruehl.
   d. The geographic area to which it applies must be reasonable.
15. John Tuck entered into a contract with Jack Doe. Doe asserts that he entered into the contract under duress. Which of the following best describes a necessary element of duress?
   a. There must have been a confidential or fiduciary relationship between Tuck and Doe.
   b. The contract entered into between Tuck and Doe was unconscionable.
   c. Doe entered into the contract with Tuck because of Tuck's improper threats.
   d. Tuck must have intended that Doe be influenced by the improper threats.

16. A written agreement was signed by both parties which was intended to be their entire agreement. The parol evidence rule will prevent the admission of evidence which is 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 which modifies the contract.
   d. Prove the existence of a subsequent oral agreement which modifies the contract.

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Items 17 and 18 are based on the following information:

Sand sold a warehouse he owned to Quick Corp. The warehouse was encumbered by an outstanding mortgage securing Sand's note to Security Bank. Quick assumed the Sand's note and mortgage at the time it purchased the warehouse from Sand. Within three months, Quick defaulted on the note and Security Bank commenced a mortgage foreclosure action. The proceeds of the resulting foreclosure sale were less than the outstanding balance on the note.

17. As to the contract between Sand and Quick, Security is
   a. A third party creditor beneficiary.
   b. A third party donee beneficiary.
   c. A third party incidental beneficiary.
   d. Not a beneficiary.

18. Which of the following statements is correct regarding the rights and liabilities of the parties?
   a. Quick's liability is limited to its equity in the warehouse.
   b. Sand remains liable on the note.
   c. Security must first proceed against Quick to recover the deficiency before seeking payment from Sand.
   d. Sand is not liable for the deficiency because Quick assumed the note and mortgage.

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19. Fiore owed Lutz $5,000. As the result of an unrelated transaction, Lutz owed Bing that same amount. The three parties signed an agreement that Fiore would pay Bing instead of Lutz and Lutz would be discharged from all liability. The agreement among the parties is
   a. Unenforceable for lack of consideration.
   b. Voidable at Bing's option.
   c. An executed accord and satisfaction.
   d. A novation.

20. Kemp entered into a contract to sell Ward a parcel of land. Kemp was aware that Ward was purchasing the land with the intention of building a high-rise office building. Kemp was also aware of the fact that a subsurface soil condition would prevent such construction. The condition was extremely unusual and not readily discoverable in the course of normal inspections or soil evaluations. Kemp did not disclose the existence of the condition to Ward, nor did Ward make any inquiry of Kemp as to the suitability of the land for his intended development. Kemp's silence as to the soil condition
   a. Renders the contract voidable at Ward's option.
   b. Renders the contract void.
   c. Will not affect the validity of the contract.
   d. Entitles Ward only to money damages.

21. Fred Gray, an employee of Gold Transport Corp., was injured when the corporate truck which he was driving struck a tree. The state in which Gold was incorporated and operated its business had a compulsory workers' compensation law. Gray will likely receive workers' compensation benefits despite the fact he
   a. Was properly excluded from coverage under the compulsory workers' compensation law.
   b. Was driving the truck outside the course of his employment at the time of the accident.
   c. Intentionally drove the truck into the tree.
   d. Was negligent by failing to adhere to Gold's safety procedures while operating the truck.

22. Jay White, an engineer, entered into a contract with Sky, Inc., agreeing to provide Sky with certain specified consulting services. After performing the services, White was paid pursuant to the contract but social security taxes were not withheld from his check since Sky considered White an independent contractor. The IRS has asserted that White was an employee and claims that a deficiency exists due to Sky's failure to withhold and pay social security taxes. Which of the following factors is most likely to support the IRS's position that White is an employee?
   a. White was paid in one lump sum after all the services were performed.
   b. White provided his own office and supplies.
   c. Sky supervised and controlled the manner in which White performed the services.
   d. Sky reserved the right to inspect White's work.
23. Which of the following agreements is not illegal per se but its legality or illegality is determined by the rule of reason under the antitrust laws?
   a. A vertical restraint contained in a franchise agreement between the manufacturer and retailer limiting the territory in which the retailer may sell.
   b. An agreement among a manufacturer and wholesalers to boycott a troublesome retailer who is selling below the manufacturer's suggested retail price.
   c. A horizontal restraint pursuant to an agreement among competitors to divide the market by geographic area.
   d. An agreement among competitors to limit the production of products in accordance with the consumer price index.

24. Fine Tools, Inc. has been charged with a violation of the provisions of the Federal Trade Commission Act section dealing with unfair methods of competition. The Federal Trade Commission Act
   a. Provides for exclusive remedies which can not be applied if there is another antitrust act under which to proceed.
   b. Applies exclusively to contracts for the sale or purchase of goods and commodities in interstate commerce.
   c. Permits the Federal Trade Commission to issue cease and desist orders in certain cases despite insufficient proof of a violation either under the Sherman or Clayton Acts.
   d. Authorizes the Federal Trade Commission to initiate and prosecute criminal actions against violators.

25. Sunk Corp. has been charged with a violation of the Robinson-Patman Act involving sales to its customers at different prices. In order to establish a prima facie case under the Robinson-Patman Act based on price discrimination it must be shown among other things that
   a. Sunk made sales of commodities of a like grade and quality to two or more customers.
   b. There was an actual and substantial lessening of competition which arose out of interstate commerce.
   c. A monopoly resulted from the alleged violation.
   d. Sunk profited from the alleged violation.

26. Lux Corp. has been suffering large losses for the past two years. Because of its inability to meet current obligations, Lux has filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. The reorganization provisions under the Bankruptcy Code
   a. Require that the court appoint a trustee in all cases.
   b. Permit Lux to remain in possession of its assets.
   c. Apply only to involuntary bankruptcy.
   d. Will apply to Lux only if Lux is required to register pursuant to the federal securities laws.

27. Fox, a sole proprietor, has been involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. Sax, CPA, has been appointed trustee of the debtor's estate. If Sax also wishes to act as the tax return preparer for the estate, which of the following statements is correct?
   a. Sax may employ himself to prepare tax returns if authorized by the court and may receive a separate fee for services rendered in each capacity.
   b. Sax is prohibited from serving as both trustee and preparer under any circumstances since serving in that dual capacity would be a conflict of interest.
   c. Although Sax may serve as both trustee and preparer, he is entitled to receive a fee only for the services rendered as a preparer.
   d. Although Sax may serve as both trustee and preparer, his fee for services rendered in each capacity will be determined solely by the size of the estate.

28. Sly has serious financial problems and is unable to meet current unsecured obligations of $30,000 to 19 creditors who are demanding immediate payment. Sly owes Kane $6,500 and Kane has decided to file an involuntary petition in bankruptcy against Sly. Which of the following is necessary in order for Kane to validly petition Sly into bankruptcy?
   a. Kane must allege and establish that Sly's liabilities exceed the fair market value of Sly's assets.
   b. Kane must be joined by at least two other creditors.
   c. Sly must have committed an act of bankruptcy within 120 days of the filing.
   d. Kane must be a secured creditor.

29. A bankrupt who has voluntarily filed for and received a discharge in bankruptcy under the liquidation provisions (Ch. 7)
   a. Is precluded from owning or operating a similar business for two years.
   b. Must surrender for distribution to the creditors amounts received as an inheritance if the receipt occurs within 180 days after filing of the petition.
   c. Will receive a discharge of any and all debts owed by him as long as he has not committed a bankruptcy offense.
   d. Can obtain another voluntary discharge in bankruptcy under Ch. 7 after five years have elapsed from the date of the prior filing.
30. Which of the following will not be discharged in a bankruptcy proceeding?
   a. Claims resulting out of an extension of credit based upon false representations.
   b. Claims of secured creditors which remain unsatisfied after their receipt of the proceeds from the disposition of the collateral.
   c. Claims for unintentional torts which resulted in bodily injury to the claimant.
   d. Claims arising out of the breach of a contract by the debtor.

31. Frost borrowed $120,000 as additional working capital for his business from Safe Bank. Safe required that the loan be collateralized to the extent of 50%, and an acceptable surety for the entire amount be obtained. Thrift Surety Co. agreed to act as surety on the loan and Frost pledged $60,000 of negotiable bearer bonds, which belonged to his wife, with Safe. Frost has defaulted. Which of the following is correct?
   a. Safe must first proceed against Frost and obtain a judgment for payment before it can proceed against the collateral.
   b. As a result of the default, Thrift and Frost's wife are co-sureties.
   c. Thrift is liable in full immediately upon default by Frost, but will upon satisfaction of the debt be entitled to the collateral.
   d. Safe must first liquidate the collateral before it can proceed against Thrift.

32. West promised to make Noll a loan of $180,000 if Noll obtained sureties to secure the loan. Noll entered into an agreement with Carr, Gray, and Pine to act as co-sureties on his loan from West. The agreement between Noll and the co-sureties provided for compensation to be paid to each of the co-sureties. It further indicated that the maximum liability of each co-surety would be as follows: Carr $180,000, Gray $60,000, and Pine $120,000. West accepted the commitment of the sureties and made the loan to Noll. After paying nine installments totaling $90,000, Noll defaulted. Gray's debts (including his surety obligation to West on the Noll loan) were discharged in bankruptcy. Subsequently, Carr properly paid the entire debt outstanding of $90,000. What amounts may Carr recover from the co-sureties?

<table>
<thead>
<tr>
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<th>Gray</th>
<th>Pine</th>
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<tbody>
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<td>a.</td>
<td>$0</td>
<td>$30,000</td>
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<td>b.</td>
<td>$0</td>
<td>$36,000</td>
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<td>c.</td>
<td>$15,000</td>
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<td>d.</td>
<td>$30,000</td>
<td>$30,000</td>
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33. Which of the following transfers by a retailer of men's clothing is subject to the Bulk Transfers Article of the UCC?
   a. A transfer of substantially all of its merchandise in the ordinary course of its business.
   b. A transfer of its entire accounts receivable.
   c. A transfer of substantially all of its equipment and merchandise outside the ordinary course of business.
   d. A pledge of a substantial portion of its inventory to secure a working capital loan.

Items 34 and 35 are based on the following information:

Queen Corp. has decided to sell its retail hardware business to Major for $90,000. Pursuant to the sales agreement, Queen transferred all of its inventory and equipment to Major. Within 45 days thereafter, Major transferred a portion of the inventory to Price. At the time of the sale, Queen owed Johnson Co. $10,000 for previous purchases of inventory.

34. If all other requirements of the Bulk Transfers Article are complied with, the transfer from Queen to Major will be effective against Johnson despite
   a. Major's failure to file a list of creditors with the Attorney General and Secretary of State within 30 days after the transfer.
   b. Major's failure to require Queen to furnish a list of Queen's existing creditors.
   c. Major's knowledge that the list of creditors prepared by Queen omitted Johnson.
   d. Major's failure to give proper notice of the transfer at least ten days before it took possession of the inventory and equipment or paid for them, whichever occurred first.

35. If Queen and Major failed to prepare a schedule of the property transferred, Price will
   a. Nevertheless receive title to the inventory free of the claim of Johnson under all circumstances.
   b. Take title subject to the claim of Johnson if Price received the inventory from Major as a gift.
   c. Always take free of the claim of Johnson if he gives value.
   d. Receive a voidable title permitting Major at its option to set aside the transfer to Price.
36. An instrument complies with the requirements for negotiability contained in the UCC Article on Commercial Paper. The instrument contains language expressly acknowledging the receipt of $40,000 by Mint Bank and an agreement to repay principal with interest at 11% six months from date. The instrument is
   a. A banker's acceptance.
   b. A banker's draft.
   c. A negotiable certificate of deposit.
   d. Nonnegotiable because of the additional language.

37. Jane Lane, a sole proprietor, has in her possession several checks which she received from her customers. Lane is concerned about the safety of the checks since she believes that many of them are bearer paper which may be cashed without endorsement. The checks in Lane's possession will be considered order paper rather than bearer paper if they were made payable (in the drawer's handwriting) to the order of
   a. Cash.
   b. Ted Tint, and endorsed by Ted Tint in blank.
   c. Bearer, and endorsed by Ken Kent making them payable to Jane Lane.
   d. Bearer, and endorsed by Sam Sole in blank.

38. The requirements for an instrument to qualify as negotiable commercial paper
   a. May be waived by a separate agreement signed by the original parties to the instrument as long as the variations are fair and voluntarily agreed upon.
   b. Prohibit substitutions or variances from the exact language of the UCC.
   c. May be satisfied by the insertion of a clause in the instrument indicating that the instrument is negotiable.
   d. Must be satisfied at least in principle, although the exact language set forth in the UCC may be varied.

39. John Daly received a check which was originally made payable to the order of one of his customers, Al Pine. The following endorsement was written on the back of the check:

   Al Pine, without recourse, for collection only

The endorsement on this check would be classified as
   a. Blank, unqualified, and non-restrictive.
   b. Blank, qualified, and restrictive.
   c. Special, unqualified, and restrictive.
   d. Special, qualified, and non-restrictive.

40. Below is a note which your client Best Realtors obtained from Green in connection with Green's purchase of land located in Rye, N.Y. The note was given for the balance due on the purchase and was secured by a first mortgage on the land.

   $90,000.00
   Rye, N.Y.
   May 1, 1985

   For value received, six years after date, I promise to pay to the order of Best Realtors NINETY THOUSAND and 00/100 DOLLARS with interest at 16% compounded annually until fully paid. This instrument arises out of the sale of land located in N.Y. and the law of N.Y. 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. Purchaser will pay the costs of collection including attorney's fees upon default.
   2. Purchaser may repay the amount outstanding on any anniversary date of this note.

   [Signature]
   Ted Green

   This note is a
   a. Negotiable promissory note.
   b. Negotiable investment security under the UCC.
   c. Nonnegotiable promissory note since it is secured by a first mortgage.
   d. Nonnegotiable promissory note since it permits prepayment and requires the maker's payment of the costs of collection and attorney's fees.

41. Hunt has in his possession a negotiable instrument which was originally payable to the order of Carr. It was transferred to Hunt by a mere delivery by Drake, who took it from Carr in good faith in satisfaction of an antecedent debt. The back of the instrument read as follows, "Pay to the order of Drake in satisfaction of my prior purchase of a new video calculator, signed Carr." Which of the following is correct?
   a. Hunt has the right to assert Drake's rights, including his standing as a holder in due course and also has the right to obtain Drake's signature.
   b. Drake's taking the instrument for an antecedent debt prevents him from qualifying as a holder in due course.
   c. Carr's endorsement was a special endorsement; thus Drake's signature was not required in order to negotiate it.
   d. Hunt is a holder in due course.
42. Frey paid Holt $2,500 by check pursuant to an agreement between them whereby Holt promised to perform in Frey's theater within the next year. Holt endorsed the check, making it payable to Len Able. Holt's status with regard to the check was one of an
a. Assignee since a payee may not also be a holder in due course.
b. Holder since Holt's promise failed to satisfy the value requirement necessary to become a holder in due course.
c. Holder in due course under the shelter rule since Able's rights as a holder in due course revert to Holt.
d. Holder in due course since all the requirements have been satisfied.

43. Blue is a holder of a check which was originally drawn by Rush and made payable to Silk. Silk properly endorsed the check to Field. Field had the check certified by the drawee bank and then endorsed the check to Blue. As a result
a. Field is discharged from liability.
b. Rush alone is discharged from liability.
c. The drawee bank becomes primarily liable and both Silk and Rush are discharged.
d. Rush is secondarily liable.

44. Ore Corp. sold 10 tons of steel to Bay Corp. with payment to be by Bay's check. Since the price of steel was fluctuating daily, Ore requested that the amount of Bay's check be left blank and it would fill in the current market price. Bay complied with Ore's request. Within two days Ore received Bay's check. Although the market price of 10 tons of steel at the time Ore received Bay's check was $40,000, Ore filled in the check for $50,000 and negotiated it to Cam Corp. Cam took the check in good faith, without notice of Ore's act or any other defense, and in payment of an antecedent debt. Bay will
a. Be liable to Cam for $50,000.
b. Be liable to Cam but only for $40,000.
c. Not be liable to Cam since the check was materially altered by Ore.
d. Not be liable to Cam since Cam failed to give value when it acquired the check from Ore.

45. Bell Co. owned 20 engines which it deposited in a public warehouse on May 5, receiving a negotiable warehouse receipt in its name. Bell sold the engines to Spark Corp. On which of the following dates did the risk of loss transfer from Bell to Spark?
a. June 11 — Spark signed a contract to buy the engines from Bell for $19,000. Delivery was to be at the warehouse.
b. June 12 — Spark paid for the engines.
c. June 13 — Bell negotiated the warehouse receipt to Spark.
d. June 14 — Spark received delivery of the engines at the warehouse.

46. Which of the following terms generally must be included in a writing which would otherwise satisfy the UCC statute of frauds regarding the sale of goods?
   a. The warranties to be granted.
   b. The price of the goods.
   c. The designation of the parties as buyer and seller.
   d. The quantity of the goods.

47. Dill purchased a computer from Park, who regularly sells computers to the general public. After receiving payment in full, Park tendered delivery of the computer to Dill. Rather than take immediate delivery, Dill stated that he would return later that day to pick up the computer. Before Dill returned, thieves entered Park's store and stole Dill's computer. The risk of loss
   a. Remained with Park since title had not yet passed to Dill.
   b. Remained with Park since Dill had not yet received the computer.
   c. Passed to Dill upon Park's tender of delivery.
   d. Passed to Dill at the time the contract was formed and payment was made.

48. Kirk Corp. sold Nix an Ajax freezer, Model 24, for $490. The contract required delivery to be made by June 23. On June 12, Kirk delivered an Ajax freezer, Model 52, to Nix. Nix immediately notified Kirk that the wrong freezer had been delivered and indicated that the delivery of a correct freezer would not be acceptable. Kirk wishes to deliver an Ajax freezer, Model 24 on June 23. Which of the following statements is correct?
   a. Kirk may deliver the freezer on June 23 without further notice to Nix.
   b. Kirk may deliver the freezer on June 23 if it first seasonably notifies Nix of its intent to do so.
   c. Nix must accept the non-conforming freezer but may recover damages.
   d. Nix always may reject the non-conforming freezer and refuse delivery of a conforming freezer on June 23.

49. A typewriter, which was subject to a prior UCC security interest, was delivered to Ed Fogel for repair. Fogel is engaged in the business of repairing typewriters. Fogel repaired the typewriter. However, the owner of the typewriter now refuses to pay for the services performed by Fogel. The state in which Fogel operates his business has a statute which gives Fogel a mechanics lien on the typewriter. Fogel's mechanics lien
   a. Takes priority over a prior perfected security interest under all circumstances.
b. Is subject to a prior perfected purchase money security interest under all circumstances.
c. Is subject to a prior unperfected security interest where the statute is silent as to priority.
d. Takes priority over a prior perfected security interest unless the statute expressly provides otherwise.
50. Under the UCC, collateral which has been sold in a private sale by a secured party to a good faith purchaser for value after the debtor's default
   a. May be redeemed by the debtor within 10 days after the disposition.
   b. May be redeemed by creditors with subordinate claims.
   c. Remains subject to the security interests of subordinate lien creditors in all cases where the collateral is disposed of at a private sale.
   d. Discharges the security interest pursuant to which such sale was made and any security interest or lien subordinate thereto.

51. Which of the following is most important in determining whether the equipment became a fixture?
   a. Whether the equipment can be removed without material damage to the building.
   b. Whether the attachment is customary for the type of building.
   c. The fair market value of the equipment at the time the lease expires.
   d. The fact that the equipment was subject to depreciation.

52. Which of the following statements is correct regarding Mini's rights and liabilities?
   a. Mini is prohibited from assigning the lease if it is silent in this regard.
   b. Mini has a possessory interest in the building.
   c. Mini is strictly liable for all injuries sustained by any person in the building during the term of the lease.
   d. Mini's rights under the lease are automatically terminated by Rein's sale of the building to a third party.

53. Jane and her brother each own a \( \frac{1}{2} \) interest in certain real property as tenants in common. Jane's interest
   a. Is considered personal property.
   b. Will pass to her brother by operation of law upon Jane's death.
   c. Will pass upon her death to the person Jane designates in her will.
   d. May not be transferred during Jane's lifetime without her brother's consent.

54. Real estate title insurance
   a. May be transferred to a subsequent bona fide purchaser for value.
   b. Assures that the purchaser will take title free and clear of all defects.
   c. Assures that the purchaser will take title free and clear of all record defects since all exceptions to title must be cleared prior to the purchaser taking possession of the realty.
   d. Is generally not required where the contract is silent on this point.

55. Which of the following statements is correct regarding Byrd's and Slade's liability to Fale?
   a. Byrd is liable to Fale for any deficiency.
   b. Byrd is secondarily liable to Fale as a surety.
   c. Slade was automatically released from all liability to Fale upon Byrd's acquisition of the building subject to the mortgage.
   d. Slade is liable to Fale for any resulting deficiency.

56. As a result of the foreclosure sale
   a. Fale is entitled to receive the full $280,000 out of the proceeds.
   b. Fale is entitled to receive $240,000 out of the proceeds.
   c. Foxx is entitled to receive its full $50,000 from either Byrd or Slade.
   d. Foxx is entitled to receive $50,000 out of the proceeds.
57. Farr obtained a $45,000 loan from State Bank, executing a promissory note and mortgage. The loan was secured by a factory which Farr purchased from Datz for $79,000. State's recording of the mortgage
   a. Cuts off the rights of all prior and subsequent lessees of the factory.
   b. Transfers legal title to the factory to State.
   c. Generally creates a possessory security interest in State.
   d. Generally does not affect the rights of Farr and State against each other under the promissory note.

58. A distinguishing feature between the making of an inter vivos gift and the creation of a trust is that
   a. A gift may be made orally whereas a trust must be in a signed writing.
   b. Generally, a gift is irrevocable whereas a trust may be revoked in certain cases.
   c. In order to create a valid trust, the creator must receive some form of consideration.
   d. The beneficiary of a trust must be notified of the trust's creation.

59. The coinsurance feature of property insurance
   a. Prevents the insured from insuring for a minimal amount and recovering in full for such losses.
   b. Precludes the insured from insuring for less than the coinsurance percentage.
   c. Is an additional refinement of the insurable interest requirement.
   d. Is fixed at a minimum of 80% by law.

60. West is seeking to collect on a property insurance policy covering certain described property which was destroyed. The insurer has denied recovery based upon West's alleged lack of an insurable interest in the property. In which of the situations described below will the insurance company prevail?
   a. West is not the owner of the insured property but a mere long-term lessee.
   b. The insured property belongs to a general trade debtor of West and the debt is unsecured.
   c. The insured property does not belong to West, but instead to a corporation which he controls.
   d. The property has been willed to West's father for life and, upon his father's death, to West as the remainderman.

Number 2 (Estimated time — 15 to 20 minutes)

Mason & Dilworth, CPAs, were the accountants for Monrad Corporation, a closely held corporation. Mason & Dilworth had been previously engaged by Monrad to perform certain compilation and tax return work. Crass, Monrad's president, indicated he needed something more than the previous type of services rendered. He advised Walker, the partner in charge, that the financial statements would be used internally, primarily for management purposes, and also to obtain short-term loans from financial institutions. Walker recommended that a review of the financial statements be performed. Walker did not prepare an engagement letter.

In the course of the review, Walker indicated some reservations about the financial statements. Walker indicated at various stages that "he was uneasy about certain figures and conclusions" but that "he would take the client's word about the validity of certain entries since the review was primarily for internal use in any event and was not an audit."

Mason & Dilworth did not discover a material act of fraud committed by management. The fraud would have been detected had Walker not relied wholly on the representations of management concerning the validity of certain entries about which he had felt uneasy.

Required: Answer the following, setting forth reasons for any conclusions stated.

   a. What is the role of the engagement letter when a CPA has agreed to perform a review of a closely held company? What points should be covered in a typical engagement letter which would be relevant to the parties under the facts set forth above?

   b. What is the duty of the CPA in the event suspicious circumstances are revealed as a result of the review?

   c. What potential liability does Mason & Dilworth face and who may assert claims against the firm?
Number 3 (Estimated time — 15 to 20 minutes)

John Nolan, a partner in Nolan, Stein, & Wolf partnership, transferred his interest in the partnership to Simon and withdrew from the partnership. Although the partnership will continue, Stein and Wolf have refused to admit Simon as a partner.

Subsequently, the partnership appointed Ed Lemon as its agent to market its various product lines. Lemon entered into a two-year written agency contract with the partnership which provided that Lemon would receive a 10% sales commission. The agency contract was signed by Lemon and, on behalf of the partnership, by Stein and Wolf.

After six months, Lemon was terminated without cause. Lemon asserts that:

• He is an agent coupled with an interest.
• The agency relationship may not be terminated without cause prior to the expiration of its term.
• He is entitled to damages because of the termination of the agency relationship.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss Nolan's property rights in the partnership prior to his withdrawal and the property rights acquired by Simon as a result of his transaction with Nolan.

b. Discuss the merits of Lemon's assertions.

Number 4 (Estimated time — 15 to 20 minutes)

John Barr purchased a new fork-lift for use in his business from Fiber Corp. Fiber designs, manufactures, and assembles fork-lifts, shipping them directly to customers throughout the U.S. The contract between Barr and Fiber contained a clause in fine print disclaiming “all warranties express or implied other than the limited warranty provided for on the face of this contract.” The limited warranty included in the contract provided that “the buyer’s sole and exclusive remedy shall be repair or replacement of defective parts and the seller shall not be liable for damages or personal injuries.” The contract was a standard form used by Fiber, and as a matter of policy Fiber does not negotiate the terms and conditions of the contract with its customers.

Within one week of the purchase date, Barr was seriously injured when the steering wheel locked causing him to lose control of the fork-lift. Barr brings an action against Fiber for the personal injuries that he sustained based on the following causes of action:

• Negligence
• Breach of warranty
• Strict liability in tort

Fiber has asserted that the action brought by Barr should be dismissed due to the disclaimer.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss in separate paragraphs the prerequisites necessary to sustain each of the three causes of action asserted by Barr.

b. Discuss the validity of the disclaimer with regard to the breach of warranty cause of action.
Uniform Certified Public Accountant Examination

Number 5 (Estimated time —— 15 to 20 minutes)

One of your firm's clients, Fancy Fashions, Inc., is a highly successful, rapidly expanding company. The company is owned predominantly by the Munn family and key corporate officers. Although additional funds would be available on a short-term basis from its bankers, this would only represent a short-term solution to the company's need for capital to fund its expansion plans. In addition, the interest rates being charged are not appealing. Therefore, John Munn, Fancy's chairman of the board, in consultation with the other shareholders, has decided to explore raising additional equity capital of approximately $4.5 to $5 million which will provide the funds necessary to continue the growth and expansion of the company. This will be Fancy's first offering to persons other than the Munn family and key management personnel.

At a meeting of Fancy's major shareholders, its attorneys and a CPA from your firm, the advantages and disadvantages of "going public" and registering an offering of its stock were discussed. One of the participants suggested that Regulation D under the Securities Act of 1933 might be a preferable alternative.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. What are the elements or factors which will determine whether Fancy's offering is required to be registered pursuant to the provisions of the Securities Act of 1933?

b. Assume there is a public offering for $4.5 million and, as a result, more than 500 persons own shares of Fancy. What implications, if any, will these facts have in respect to the Securities Exchange Act of 1934?

c. What federal civil and criminal liabilities may apply in the event that Fancy sells the securities without a registration and an exemption to registration is not available?

d. Discuss the exemption applicable to offerings of up to $5 million (under Rule 506 of Regulation D) in terms of:

1. What are the two kinds of and the number of investors who may participate?
2. Are audited financial statements required?
3. What restrictions apply to the manner or way the securities may be sold?
The scores for the multiple choice questions were determined in accordance with the following scale:

| Correct | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 0 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15  | 16  | 17  | 18  | 19  | 20  | 21  | 22  | 23  | 24  | 25  |    |

| Correct | 21 | 22 | 23 | 24 | 25 | 26 | 27 | 28 | 29 | 30 | 31  | 32  | 33  | 34  | 35  | 36  | 37  | 38  | 39  | 40  | 41  | 42  | 43  | 44  | 45  |
|---------|----|----|----|----|----|----|----|----|----|----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| Score   | 26 | 27 | 28 | 29 | 30 | 31  | 32  | 33  | 34  | 35  | 36   | 37   | 38   | 39   | 40   | 41   | 42   | 43   | 44   | 45   |    |    |    |    |

| Correct | 41 | 42 | 43 | 44 | 45 | 46 | 47 | 48 | 49 | 50 | 51  | 52  | 53  | 54  | 55  | 56  | 57  | 58  | 59  | 60  |    |    |    |    |
|---------|----|----|----|----|----|----|----|----|----|----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| Score   | 46 | 47 | 48 | 49 | 50 | 51  | 52  | 53  | 54  | 55  | 56   | 57   | 58   | 59   | 60   | 60   | 60   | 60   | 60   |    |    |    |    |

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Answer 2 (10 points)

a. The role of the engagement letter is to set forth in writing the nature and limitations of the engagement and define the arrangement between the CPA and his client. The engagement letter should clearly and precisely state the type of engagement contemplated and the scope of such an undertaking. It should indicate the procedures and steps to be taken in the review and indicate the tests that will be performed. It should also state that the engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcation, but the CPA will inform his client of any such matters that come to his attention. The engagement letter or an acknowledgement should be signed by the client. If the engagement letter is carefully prepared and if it spells out the engagement clearly, it will play an important role if a dispute arises between the CPA and his client. The engagement letter will also help the courts to avoid any misunderstanding about the scope of the engagement.

b. Under such circumstances, the courts that have considered the question and SSARS No. 1 promulgated by the AICPA both impose a duty of inquiry when the CPA becomes aware of suspicious circumstances. Certainly, the mere reliance upon management's word is not sufficient. The facts indicated that Walker was "uneasy about certain figures and conclusions." The CPA has an obvious duty to the client, Monrad, to inquire into any suspicious circumstances of which he becomes aware.

c. Depending on the circumstances about who in management was involved and their ownership of stock, Monrad in its own right may bring an action or the shareholders may bring a derivative action against Mason & Dilworth on behalf of the corporation for negligently failing to detect the fraud. It is possible that an action based upon constructive fraud might also be asserted against the firm because the conduct might be categorized as gross negligence or a reckless disregard for the truth. Certainly, a shareholder in his own right and any of the lending institutions will assert this and privity of contract will not be a valid defense.

There is authority supporting the rights of third party plaintiffs to sue and to recover from the accountants based upon a negligently performed review. As a general rule, third parties, even though not parties to the contract, may successfully assert negligence if they can show that they are members of a class of persons intended to benefit from the services performed by the CPA and that this was reasonably foreseeable by the CPA.

Answer 3 (10 points)

a. Nolan's property rights in the partnership prior to the conveyance of his partnership interest consisted of:

- His rights in specific partnership property. This right permitted Nolan to possess any item of partnership property for partnership purposes.
- His interest in the partnership. This interest is classified as personal property and is defined as the partner's share of the profits and surplus (including capital).
- His right to participate in the management of the partnership. This right entitles Nolan to an equal voice in the management and conduct of the partnership business.

Nolan's transfer of his partnership interest to Simon merely entitles Simon to receive Nolan's share of the profits and Nolan's interest in any property distributed by the partnership. Since Stein and Wolf have refused to admit Simon as a partner, Simon will not be entitled to participate in the management of the partnership or to acquire Nolan's right to possess specific partnership property.

b. Lemon's first assertion that he is an agent coupled with an interest is incorrect. An agency coupled with an interest in the subject matter arises when the agent has an interest in the property that is the subject of the agency. The fact that Lemon entered into a two-year written agency agreement with the partnership that would pay Lemon a commission clearly will not establish an interest in the subject matter of the agency. The mere expectation of profits to be realized or proceeds to be derived from the sale of the partnership's products is not sufficient to create an agency coupled with an interest. As a result, the principal-agency relationship may be terminated at any time.

Lemon's second assertion that the principal-agency relationship may not be terminated without cause prior to the expiration of its term is incorrect. Where a principal-agency relationship is based upon a contract to engage the agent for a specified period of time, the principal may discharge the agent despite the fact such discharge is wrongful. Although the principal does not have the right to discharge the agent, he does have the power to do so. Thus, Lemon may be discharged without cause.

Lemon's third assertion that he is entitled to damages because of the termination of the agency relationship is incorrect. Where a principal wrongfully discharges its agent, the principal is liable for damages based on breach of contract. Under the facts, Lemon's discharge by the partnership without cause constitutes a breach of contract for which Lemon may recover damages.
Answer 4 (10 points)

a. Negligence. In order to establish a cause of action based on negligence Barr must establish the following elements:

- That the defendant owed a legal duty to the plaintiff.
- That the defendant breached that duty.
- That the plaintiff sustained an actual loss or damages.
- That the breach of duty was the proximate cause of the plaintiff’s actual loss or damages.

In determining if negligence is present the court will consider whether the defendant acted as a reasonably prudent person under the circumstances. Included in the reasonably prudent person test is whether the risk of harm was foreseeable.

Breach of Warranty. Since the sale of goods (the fork-lift) is involved in the contract, the UCC Sales Article applies. Because the seller would be regarded as a merchant, an implied warranty of merchantability is created. In order to establish a breach of this warranty, the plaintiff (Barr) must show:

- That the fork-lift was not fit for the ordinary purposes intended and
- That as a result of the breach of warranty, the plaintiff sustained a loss.

Strict Liability in Tort. Generally, the elements necessary to establish a cause of action based on strict liability in tort are as follows:

- That the product was in defective condition when it left the possession or control of the seller.
- That the product was unreasonably dangerous to the consumer or user.
- That the cause of the consumer’s or user’s injury was the defect.
- That the seller engaged in the business of selling such a product.
- That 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.

Proof of fault is not a requirement to establish a cause of action in strict liability.

b. A proper disclaimer will permit the seller to exclude the implied warranty of merchantability. Under the facts, the disclaimer would appear to be invalid since a written disclaimer of the implied warranty of merchantability must be conspicuous and, arguably, the language in the contract is not acceptable under the UCC. In this case the disclaimer was in fine print and therefore not conspicuous. In addition, the disclaimer may be considered unconscionable since the contract was standardized and no bargaining of the terms of the contract was permitted. It should be pointed out that although consequential damages may be limited or excluded, in the case of consumer goods limitation of consequential damages for personal injuries is prima facie unconscionable. However, since the facts do not relate to consumer goods, such limitation of damages is not prima facie unconscionable but may be proved to be unconscionable.
**Answer 5** (10 points)

a. There are four elements or factors to be considered in determining whether an offering of securities is subject to the registration requirements of the Securities Act of 1933. These are:

- The use of interstate commerce, e.g., the mails, in connection with the offer to sell or the sale of securities.
- The offering of said securities is to the "public".
- The offering or sale is made by an issuer, controlling person, or "statutory" underwriter.
- There is no relevant exemption available.

b. Since the sale of equity securities results in more than 500 persons owning Fancy stock, coupled with the fact that Fancy will have more than $3 million of assets, the corporation will be subjected to the full application of the Securities Exchange Act of 1934. As such, it will be required to register pursuant to the Act and thereby become subject to the Act's reporting, insider trading, proxy, and other requirements.

c. The Securities Act of 1933 provides that where there is a violation of the Act as a result of the failure to file a registration statement, the parties responsible shall be liable upon tender of the securities purchased for the amount paid, plus interest, less any distributions received.

Damages are recoverable even if the party no longer owns the securities. Criminal penalties of a fine or imprisonment or both are applicable to any person who willfully violates the Securities Act of 1933.

d. An offering pursuant to Regulation D is exempt from registration. Regulation D is intended to permit exemption from registration of limited offers and sales by small businesses in need of capital.

1. There are two kinds of investors under Rule 505 of Regulation D: accredited investors as defined in the Regulation and all others who are designated as non-accredited investors. An unlimited number of accredited investors is permitted, but a maximum of 35 non-accredited investors is permitted.

2. Under Rule 505, if non-accredited investors are involved and Fancy is a non-reporting company under the Securities Exchange Act of 1934, it must supply audited financial statements for one year. If an audit of the most recent year would involve unreasonable effort or expense, an audited balance sheet only, dated within 120 days of the start of the offering, is permitted.

3. Rule 505 prohibits any general solicitation or general advertising of the securities within a 12-month period.
SUGGESTED REFERENCES

Business Law

Number 1

Clarkson, Miller, and Jentz, West's Business Law: Text and Cases (West, 1983).
Minars, Business Law (Kendall/Hunt, 1984).
Schantz, Commercial Law for Business and Accounting Students (West, 1980).
Smith, Roberson, Mann, and Roberts, Business Law, UCC 5th ed. (West, 1982).
Thompson and Brady, Antitrust Fundamentals, 3d ed. (West, 1979).
Bankruptcy Code.
Model Business Corporation Act.
Robinson-Patman Act.
Uniform Commercial Code.

Number 2


Number 3

Uniform Partnership Act, Secs. 17, 18, 24, 25, 26, 27, 38.

Number 4

Restatement of Torts, 2d, Sec. 402A.
Uniform Commercial Code, Secs. 2-302, 2-313 comment 4, 2-314, 2-316, 2-318, 2-719.

Number 5

Securities Act of 1933, Secs. 4, 5, 12, Regulation D, Secs. 501-506.
INDEX — QUESTIONS

HOW TO USE THIS INDEX: This index presents examination question number references according to the areas and groups within the Business Law Content Specification Outline. The Appendix located at the back of this book contains the content specification outlines for the four sections of the CPA examination.

The question references listed in the right hand column are designated as follows: The question numbers are followed by the page number (in parentheses) in this book. The letter M following question numbers indicates a multiple choice item. For example, the reference 17M(AP-250) means multiple choice item number 17 on page AP-250; the reference 5(AP-258) means essay or problem number 5 on page AP-258. Note that no distinction has been made between Accounting Practice, Parts I and II.

Business Law — Content Specification Outline

I. The CPA and the Law.
   A. Common Law Liability to Clients and Third Persons ........................................2(B-116)
   B. Federal Statutory Liability
   C. Workpapers, Privileged Communication, and Confidentiality

II. Business Organizations.
   A. Agency ..........................................................3(B-117)
   B. Partnerships and Joint Ventures ........................................3(B-117)
   C. Corporations ..............................................2M(B-108),3M(B-108),4M(B-108),5M(B-108)
   D. Estates and Trusts ........................................58M(B-116)

III. Contracts.
   A. Offer and Acceptance ....................................7M(B-109),8M(B-109),11M(B-109)
   B. Consideration ..............................................13M(B-109)
   C. Capacity, Legality, and Public Policy ..............14M(B-109)
   D. Statute of Frauds ..........................................9M(B-109)
   E. Statute of Limitations ...................................
   F. Fraud, Duress, and Undue Influence ...............10M(B-109),15M(B-110)
   G. Mistake and Misrepresentation ....................12M(B-109),20M(B-110)
   H. Parole Evidence Rule ....................................16M(B-110)
   I. Third Party Rights .......................................17M(B-110)
   J. Assignments ..................................................6M(B-109)
   K. Discharge, Breach, and Remedies .................18M(B-110),19M(B-110)

IV. Debtor-Creditor Relationships.
   A. Suretyship ..................................................31M(B-112),32M(B-112)
   B. Bankruptcy .................................................26M(B-111),27M(B-111),28M(B-111),29M(B-111),30M(B-112)

V. Government Regulation of Business.
   A. Regulation of Employment .........................21M(B-110),22M(B-110)
   B. Federal Securities Acts ..............................5(B-118)
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Business Law — Content Specification Outline

VI. Uniform Commercial Code.
   A. Commercial Paper .................................................. 36M(B-113), 37M(B-113), 38M(B-113), 39M(B-113),
      40M(B-113), 41M(B-113), 42M(B-114), 43M(B-114),
      44M(B-114)
   B. Documents of Title and Investment Securities .......... 45M(B-114)
   C. Sales ................................................................. 46M(B-114), 47M(B-114), 48M(B-114), 4(B-117)
   D. Secured Transactions ............................................ 49M(B-114), 50M(B-115)

VII. Property.
   A. Real and Personal Property .................................... 51M(B-115), 52M(B-115), 53M(B-115), 54M(B-115)
   B. Mortgages ............................................................ 55M(B-115), 56M(B-115), 57M(B-116)
   C. Fire and Casualty Insurance ................................... 59M(B-116), 60M(B-116)
APPENDIX

CONTENT SPECIFICATION OUTLINES
APPENDIX

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 1986 Uniform CPA Examination, are based upon the results of the practice analysis study.

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 area. 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,
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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 scope of the Accounting Practice section includes 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, Internal Revenue Code and Income Tax Regulations, accounting textbooks, leading accounting journals, 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 Changes in Financial Position
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 Doubtful 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
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E. Intangibles and Other Assets

1. Goodwill
2. Patents
3. Other Intangibles
4. Prepaid Expenses
5. Deferred Income Taxes
6. Deferred Pension Costs

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. Accrued Pension Expense
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 Timing 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. Legal Capital
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4. Retirement of Stock
5. Book Value Per Share
6. 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 (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 Goods Sold
   2. General and Administrative
   3. Selling
   4. Financial (interest)
   5. Depreciation, Amortization, and Depletion
   6. Research and Development

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7. Foreign Exchange
8. Bad Debts
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
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
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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. Gross Profit Analysis
6. Differential Cost Analysis
7. 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. Reserved for Encumbrances
6. Revenues
7. Expenditures

B. Types of Funds and Fund Accounts
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. Special Assessment Funds
9. General Fixed Assets Account Group
10. General Long-Term Debt Account Group
11. Endowment and Quasi-Endowment Funds
12. Restricted Funds and Unrestricted Funds
13. 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
Appendix

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
Appendix

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, accounting textbooks, leading accounting journals, 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

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Appendix

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 Doubtful 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 Taxes
6. Deferred Pension Costs

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. Accrued Pension Expense
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 Timing Differences
Appendix

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. Legal Capital
   4. Retirement of Stock
   5. Book Value Per Share
   6. 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

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Appendix

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 Goods Sold
2. General and Administrative
3. Selling
4. Financial (interest)
5. Depreciation, Amortization, and Depletion
6. Research and Development
7. Foreign Exchange
8. Bad Debts
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 Changes in Financial Position
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. 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. Gross Profit Analysis
   6. Differential Cost Analysis
   7. 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. Reserved for Encumbrances
   6. Revenues
   7. Expenditures

C. Types of Funds and Fund Accounts
   1. General Fund
   2. Special Revenue Funds
   3. Debt Service Funds
   4. Capital Projects Funds
Appendix

5. Enterprise Funds
6. Internal Service Funds
7. Trust and Agency Funds
8. Special Assessment Funds
9. General Fixed Assets Account Group
10. General Long-Term Debt Account Group
11. Endowment and Quasi-Endowment Funds
12. Restricted and Unrestricted Funds
13. 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 auditing procedures. The section includes professional responsibilities, internal control, audit evidence and procedures, and reporting.

In preparing for this section, candidates should study publications such as the following:

- AICPA Code of Professional Ethics.
- Statements on 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.
- AICPA Audit Guides.
- Auditing textbooks.
- Leading accounting journals.

Auditing — Content Specification Outline

I. Professional Responsibilities (15 percent)
   A. General Standards and Rules of Conduct
      1. Proficiency, Independence, and Due Care
      2. Rules of Conduct
   B. Control of the Audit
      1. Planning and Supervision
      2. Quality Control
   C. Other Responsibilities
      1. Client Errors, Management Fraud, and Defalcations
      2. Client Illegal Acts
      3. Responsibilities in Review and Compilation
      4. Responsibilities in Management Advisory Services
      5. Responsibilities in Tax Practice
II. Internal Control (30 percent)

A. Definitions and Basic Concepts
   1. Purpose of Auditor’s Study and Evaluation
   2. Definitions and Basic Concepts

B. Study and Evaluation of the System
   1. Review of the System
   2. Tests of Compliance
   3. Evaluation of Weaknesses

C. Cycles
   1. Sales, Receivables, and Cash Receipts
   2. Purchases, Payables, and Cash Disbursements
   3. Inventories and Production
   4. Personnel and Payroll
   5. Property, Plant, and Equipment

D. Other Considerations
   1. Required Communication of Material Weaknesses
   2. Reports on Internal Control
   3. Sampling
   4. Flowcharting

III. Evidence and Procedures (30 percent)

A. Audit Evidence
   2. Analytical Review Procedures
   3. Evidential Matter for Receivables and Inventory
   4. Evidential Matter for Long-Term Investments
   5. Client Representations
   6. Using the Work of a Specialist
   7. 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. Operational 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 Review
   3. Unusual Matters
   4. Other Procedures
Appendix

IV. Reporting (25 percent)

A. Reporting Standards and Types of Reports

1. Scope of Examination
2. Generally Accepted Accounting Principles
3. Consistency
4. Disclosure
5. Reporting Responsibilities
6. Unqualified
7. Qualified
8. Adverse
9. Comparative
10. Disclaimer
11. Review and Compilation
12. Review of Interim Financial Information
13. Special Reports
14. Negative Assurance
15. Prospective Financial Statements

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. Supplementary Information Required by the FASB
8. Information Accompanying the Basic Financial Statements

Business Law Section

The Business Law section tests the candidates' knowledge of the legal implications in business transactions, particularly as they may 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. Many of the subjects on the examination are normally covered in standard textbooks on business law, auditing, taxation, and accounting; however, some subjects either are not included in such texts or are not covered in adequate depth. Important recent developments with which candidates are expected to be familiar may not yet be reflected in some texts. Candidates are expected to recognize the existence of legal implications and the 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 nor expertise in legal matters, but to determine that the candidates' knowledge is sufficient to (1) recognize relevant legal issues, (2) recognize the legal implications of business situations, (3) apply the underlying principles of law to accounting and auditing situations, and (4) 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

1. The CPA and the Law (10 percent)
   A. Common Law Liability to Clients and Third Persons
Appendix

B. Federal Statutory Liability
   1. Securities Acts
   2. Internal Revenue Code

C. Workpapers, Privileged Communication, and Confidentiality

II. Business Organizations (15 percent)
   A. Agency
      1. Formation and Termination
      2. Liabilities of Principal for Tort and Contract
      3. Disclosed and Undisclosed Principals
      4. Agent’s Authority and Liability
   B. Partnerships and Joint Ventures
      1. Formation and Existence of Partnerships
      2. Liabilities and Authority of Partners and Joint Owners
      3. Transfer of Partnership Interest
      4. 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 Purpose
      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 and Consumer Protection (10 percent)
   A. Suretyship
      1. Liabilities and Defenses
      2. Release of Parties
      3. Remedies of Parties
Appendix

B. Bankruptcy
   1. Voluntary and Involuntary Bankruptcy
   2. Effects of Bankruptcy on Debtors 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. Workmen’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 Agreements
      2. Perfection of Security Interests
      3. Priorities
      4. Rights of Debtors, Creditors, and Third Parties

VII. Property, Estates, and Trusts (10 percent)
   A. Real and Personal Property
      1. Distinctions Between Realty and Personality
      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. Administration of Estates and Trusts
D. Fire and Casualty Insurance
   1. Coinsurance
   2. Multiple Insurance Coverage
   3. Insurable Interest