1987

Uniform CPA Examination, May 1983-May 1987, Selected Questions & Unofficial Answers Indexed To Content Specification Outlines

James D. Blum
Steven Rubin
Bruce H. Biskin

American Institute of Certified Public Accountants. Board of Examiners

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Uniform CPA Examination
May 1983-May 1987

Selected Questions & Unofficial Answers
Indexed To Content Specification Outlines

Accounting Practice
Accounting Theory
Auditing
Business Law

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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 1987 back to May 1983. 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 (83 through 87), 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 1987 Uniform CPA Examination are included at the end of the book. Following the November 1987 exam's questions and unofficial answers is an index of the exam's questions which classifies them in accordance with each section's Content Specification Outline.

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

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

George R. Dick, Vice President—Review & Regulation
American Institute of Certified Public Accountants

January 1988
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CSO-1
MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Presentation of Financial Statements or Worksheets

C. Statement of Changes in Financial Position

2M83

Items 24 through 30 are based on the following information:

**Best Corporation**

**INCOME STATEMENTS**

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1982</td>
</tr>
<tr>
<td>Credit sales</td>
<td>$6,300,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>4,900,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,400,000</td>
</tr>
<tr>
<td>Expenses (including income taxes)</td>
<td>700,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

**Best Corporation**

**BALANCE SHEETS**

<table>
<thead>
<tr>
<th></th>
<th>December 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1982</td>
</tr>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Current assets:</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$480,000</td>
</tr>
<tr>
<td>Accounts receivable —net</td>
<td>840,000</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>760,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>2,080,000</td>
</tr>
<tr>
<td>Land, buildings, and fixtures</td>
<td>1,330,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>210,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$3,200,000</td>
</tr>
</tbody>
</table>

**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:

<table>
<thead>
<tr>
<th>($10 par value)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td></td>
</tr>
<tr>
<td>Balance, 1/1</td>
<td>$900,000</td>
</tr>
<tr>
<td>Sold, 4/1/82</td>
<td>100,000</td>
</tr>
<tr>
<td>20% stock dividend, 6/1/82</td>
<td>200,000</td>
</tr>
<tr>
<td>Balance, 12/31</td>
<td>$1,200,000</td>
</tr>
</tbody>
</table>

| 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 |

| Retained earnings |       |
| Balance, 1/1 | $330,000 | $250,000 |
| Net income | 700,000  | 170,000  |
| Cash dividends | (125,000) | (90,000) |
| Stock dividends | (275,000) | — |
| Balance, 12/31 | $630,000 | $330,000 |

**CHANGES IN STOCKHOLDERS' EQUITY**

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1982</td>
</tr>
<tr>
<td>Common stock</td>
<td></td>
</tr>
<tr>
<td>Balance, 1/1</td>
<td>$ 900,000</td>
</tr>
<tr>
<td>Sold, 4/1/82</td>
<td>100,000</td>
</tr>
<tr>
<td>20% stock dividend, 6/1/82</td>
<td>200,000</td>
</tr>
<tr>
<td>Balance, 12/31</td>
<td>$1,200,000</td>
</tr>
</tbody>
</table>

| 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 |

| Retained earnings |       |
| Balance, 1/1 | $330,000 | $250,000 |
| Net income | 700,000  | 170,000  |
| Cash dividends | (125,000) | (90,000) |
| Stock dividends | (275,000) | — |
| Balance, 12/31 | $630,000 | $330,000 |

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.

AP-1
Accounting Practice

- 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

E. Consolidated Financial Statements or Worksheets

2M87

Items 4 through 11 are based on the following data:

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

**BALANCE SHEETS**
December 31, 1986

<table>
<thead>
<tr>
<th>Assets</th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$150,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>190,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>430,000</td>
<td>150,000</td>
</tr>
</tbody>
</table>

**Assets**

<table>
<thead>
<tr>
<th></th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant, and</td>
<td>365,000</td>
<td>200,000</td>
</tr>
<tr>
<td>equipment (net)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Sub</td>
<td>315,000</td>
<td></td>
</tr>
<tr>
<td>(equity method)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,110,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

**Liabilities and Stockholders' Equity**

Current liabilities
- Accounts payable: $100,000 ($60,000)
- Accrued liabilities: $30,000 ($20,000)

Total current liabilities: $130,000 ($80,000)

Stockholders' equity
- Common stock ($10 par): $220,000 ($30,000)
- Additional paid-in capital: $140,000 ($100,000)
- Retained earnings: $620,000 ($140,000)

Total stockholders' equity: $980,000 ($270,000)

Total liabilities and stockholders' equity: $1,110,000 ($350,000)

**INCOME STATEMENTS**
For the Year Ended December 31, 1986

<table>
<thead>
<tr>
<th></th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,000,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>770,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>230,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>130,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>100,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Equity in earnings of Sub</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>125,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>40,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$85,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Additional information:
- On January 1, 1986, Par purchased for $300,000 all of Sub's $10 par, voting common stock. On January 1, 1986, the fair value of Sub's assets and liabilities equaled their carrying amount of $330,000 and $80,000, respectively. Par's policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.
Selected Questions

- During 1986, Par and Sub paid cash dividends of $50,000 and $10,000, respectively. For tax purposes, Par receives the 100% exclusion for dividends received from Sub.

- There were no intercompany transactions except for Par's receipt of dividends from Sub, and Par's recording of its share of Sub's earnings.

- On June 30, 1986, Par issued 2,000 shares of common stock for $17 per share. There were no other changes in either Par's or Sub's common stock during 1986.

- Both Par and Sub paid income taxes at the rate of 40%.

4. In the 1986 consolidated income statement of Par and its subsidiary, Sub, what amount should be reported as consolidated net income?

a. $60,000  
b. $85,000  
c. $90,000  
d. $115,000

5. The consolidated balance sheet of Par and its subsidiary, Sub, should report total consolidated assets of

a. $1,110,000  
b. $1,145,000  
c. $1,190,000  
d. $1,460,000

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

A. Cash, Marketable Securities, and Investments

1M87#1. On January 1, 1986, Carr Company purchased Fay Corp. 9% bonds with a face amount of $400,000 for $375,600, to yield 10%. The bonds are dated January 1, 1986, mature on December 31, 1995, and pay interest annually on December 31. Carr uses the interest method of amortizing bond discount. In its income statement for the year ended December 31, 1986, what total amount should Carr report as interest revenue from the long-term bond investment?

a. $40,000  
b. $37,560  
c. $36,000  
d. $34,440

1M87

Items 3 and 4 are based on the following data:

Taft, Inc., began operations on January 1, 1986. At December 31, 1986, Taft had the following investment portfolios of marketable equity securities:

<table>
<thead>
<tr>
<th>$275,000</th>
<th>$210,000</th>
<th>$225,000</th>
</tr>
</thead>
</table>

6. The consolidated balance sheet of Par and its subsidiary, Sub, should report total retained earnings of

a. $620,000  
b. $640,000  
c. $650,000  
d. $760,000

7. In the consolidated income statement of Par and its subsidiary, Sub, how much expense should be reported for amortization of goodwill?

a. $0  
b. $3,000  
c. $5,000  
d. $10,000

9. In the December 31, 1986 consolidated balance sheet of Par and its subsidiary, Sub, how much should be reported as total current assets?

a. $150,000  
b. $280,000  
c. $430,000  
d. $580,000

The market declines are judged to be temporary.

3. In its 1986 income statement, what amount should Taft report as unrealized loss on marketable equity securities?

a. $20,000  
b. $28,000  
c. $70,000  
d. $93,000

AP-3
4. In its December 31, 1986 balance sheet, Taft should report valuation allowances for current and non-current marketable equity securities respectively at
   a. $20,000 and $50,000.
   b. $20,000 and $0.
   c. $28,000 and $65,000.
   d. $28,000 and $50,000.

1M86#18. On January 2, 1986, Saxe Company purchased 29% of Lex Corporation's common stock for $150,000. This investment did not give Saxe the ability to exercise significant influence over Lex. During 1986 Lex reported net income of $175,000, and paid cash dividends of $100,000 on its common stock. The balance in Saxe's investment in Lex Corporation account at December 31, 1986, should be
   a. $130,000
   b. $150,000
   c. $165,000
   d. $185,000

2M86#15. The following information pertains to Nu Co. at December 31, 1985:

Check book balance $6,000
Bank statement balance 8,000
Check drawn on Nu Co.'s account, payable to a vendor, dated and recorded, 12/31/85, but not mailed until 1/20/86 900

On Nu Co.'s balance sheet at December 31, 1985, how much should be shown as cash?
   a. $6,000
   b. $6,900
   c. $7,100
   d. $8,000

1M86#1. Orr Company had the following bank reconciliation at March 31, 1986:

Balance per bank statement, 3/31/86 $46,500
Add: Deposit in transit 10,300 56,800
Less: Outstanding checks 12,600
Balance per books, 3/31/86 $44,200

Data per bank statement for the month of April 1986 follow:

Deposits $58,400
Disbursements 49,700

All reconciliation items at March 31, 1986, cleared through the bank in April. Outstanding checks at April 30, 1986, totaled $7,500. What is the amount of cash disbursements per books in April?
   a. $44,600
   b. $49,700
   c. $54,800
   d. $57,200

1M86#2. On its December 31, 1984, balance sheet, Fay Company appropriately reported a $2,000 credit balance in its Allowance to Reduce Temporary Investments to Lower of Cost or Market. There was no change during 1985 in the composition of Fay's portfolio of marketable equity securities held as a temporary investment. Pertinent data are as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market value at 12/31/85</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$60,000</td>
<td>$63,000</td>
</tr>
<tr>
<td>B</td>
<td>45,000</td>
<td>40,000</td>
</tr>
<tr>
<td>C</td>
<td>80,000</td>
<td>78,500</td>
</tr>
<tr>
<td></td>
<td>$185,000</td>
<td>$181,500</td>
</tr>
</tbody>
</table>

What amount of loss on these securities should be included in Fay's income statement for the year ended December 31, 1985?
   a. $0
   b. $1,500
   c. $3,500
   d. $4,500

1M86#3. Neal Company held the following marketable securities as long-term investments at December 31, 1985:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>10,000 shares of Company A nonredeemable preferred stock, par value $75</td>
<td>$775,000 $825,000</td>
</tr>
<tr>
<td>7,000 shares of Company B preferred stock, par value $100, subject to mandatory redemption by the issuer at par on 12/31/90</td>
<td>690,000 625,000</td>
</tr>
<tr>
<td>In Neal's December 31, 1985, balance sheet, marketable securities should be reported at</td>
<td></td>
</tr>
<tr>
<td>a. $1,400,000</td>
<td></td>
</tr>
<tr>
<td>b. $1,450,000</td>
<td></td>
</tr>
<tr>
<td>c. $1,465,000</td>
<td></td>
</tr>
<tr>
<td>d. $1,475,000</td>
<td></td>
</tr>
</tbody>
</table>

1M86#5. On January 1, 1985, Dell Company paid $1,800,000 for 50,000 shares of Case Company's common stock which represents a 25% investment in the net assets of Case. Dell has the ability to exercise significant influence over Case. Dell received a dividend of $3.50 per share from Case in 1985. Case reported net income of $960,000 for the year ended December 31, 1985. In its December 31, 1985, balance sheet, Dell should report the investment in Case Company at
   a. $2,215,000
   b. $2,040,000
   c. $1,865,000
   d. $1,800,000

AP-4
Selected Questions

1M85#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></th>
<th>In current assets</th>
<th>In noncurrent assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate cost</td>
<td>$150,000</td>
<td>$225,000</td>
</tr>
<tr>
<td>Aggregate market value</td>
<td>120,000</td>
<td>185,000</td>
</tr>
<tr>
<td>Net unrealized loss</td>
<td>$ 30,000</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 equity.

<table>
<thead>
<tr>
<th>Income</th>
<th>Stockholders’ equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$70,000</td>
</tr>
<tr>
<td>b.</td>
<td>$40,000</td>
</tr>
<tr>
<td>c.</td>
<td>$30,000</td>
</tr>
<tr>
<td>d.</td>
<td>$0</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. 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

1M85#3. 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

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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></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>28,400</td>
</tr>
<tr>
<td>Balance per books, 3/31/85</td>
<td>$22,100</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#5. 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
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 a(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

1N84#3. 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

1N84#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#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

1M84#3. 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 pur-
chased 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 in-
vestment?
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 bal-
ances 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 re-
ported 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 state-
ments 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 se-
curities portfolio:
Cost $500,000
Market value, 12/31/82 400,000
Market value, 1/22/83 350,000
Market value, 2/3/83 300,000

How much should be reported on Denso’s balance
sheet at December 31, 1982, for marketable equity se-
curities?
a. $500,000
b. $400,000
c. $350,000
d. $300,000

Selected Questions

B. Receivables and Accruals

1M87#2. Dean, Inc., owns 100% of Roy Corporation,
a consolidated subsidiary, and 80% of Wall, Inc., an
unconsolidated subsidiary at December 31, 1986. The
same date, Dean has receivables of $200,000 from Roy
and $175,000 from Wall. In its December 31, 1986 con-
solidated balance sheet, Dean should report accounts
receivable from investees at
a. $0
b. $35,000
c. $175,000
d. $235,000

1M87#6. On July 1, 1986, Park Company leased office
space for ten years to Rudd at a monthly rental of
$15,000, and received the following amounts:
First month’s rent $15,000
Security deposit 25,000

Rudd made timely rent payments through November
1986; the December rent was paid, together with the
January 1987 rent, on January 6, 1987. At December
31, 1986, Park should report rent receivable of
a. $0
b. $5,000
c. $15,000
d. $30,000

1M87#12. Grey Company holds an overdue note re-
ceivable of $800,000 plus recorded accrued interest of
$64,000. As the result of a court imposed settlement
on December 31, 1986, Grey agreed to the following
restructuring arrangement:

- Reduced the principal obligation to $600,000.
- Forgave the $64,000 accrued interest.
- Extended the maturity date to December 31, 1988.
- Annual interest of $60,000 is to be paid to Grey on

On December 31, 1986, Grey must recognize a loss
from restructuring of
a. $144,000
b. $200,000
c. $204,000
d. $264,000

2N86#3. All of Ladd Co.’s sales are on a credit basis.
The following information is available for 1985:

Allowance for doubtful accounts, 1/1/85 $9,000
Sales 475,000
Sales returns 40,000
Accounts written off
as uncollectible 10,000

AP-7
Ladd provides for doubtful accounts expense at the rate of 3% of net sales. At December 31, 1985, the allowance for doubtful accounts balance should be
a. $14,050
b. $13,250
c. $13,050
d. $12,050

2M86#4. On June 30, 1985, Ray Co. discounted at the bank a customer’s $60,000, 6-month, 10% note receivable dated April 30, 1985. The bank discounted the note at 12%. Ray’s proceeds from this discounted note amounted to
a. $56,400
b. $57,600
c. $60,480
d. $61,740

2M86#18. An analysis and aging of Jay Co.’s accounts receivable at December 31, 1985, disclosed the following:

Accounts receivable $900,000
Allowance for uncollectible accounts, per books 50,000
Accounts estimated to be uncollectible 64,000

At December 31, 1985, the net realizable value of accounts receivable should be
a. $886,000
b. $850,000
c. $836,000
d. $786,000

1M86
Items 6 and 7 are based on the following data:

Rex Company had the following information relating to its accounts receivable at December 31, 1984, and for the year ended December 31, 1985:

Accounts receivable at 12/31/84 $1,200,000
Allowance for doubtful accounts at 12/31/84 60,000
Credit sales for 1985 5,300,000
Collections from customers for 1985 4,650,000
Accounts written off 9/30/85 75,000
Estimated uncollectible receivables per aging of receivables at 12/31/85 110,000

6. At December 31, 1985, Rex’s allowance for doubtful accounts should be
a. $135,000
b. $125,000
c. $110,000
d. $95,000

7. At December 31, 1985, Rex’s accounts receivable, before the allowance for doubtful accounts, should be
a. $1,850,000
b. $1,835,000
c. $1,815,000
d. $1,775,000

1M86#9. Cobb, Inc., has current receivables from affiliated companies at December 31, 1985, as follows:

- A $75,000 cash advance to Hill Corporation. Cobb owns 30% of the voting stock of Hill and accounts for the investment by the equity method.
- A receivable of $260,000 from Vick Corporation for administrative and selling services. Vick is 100% owned by Cobb and is included in Cobb’s consolidated financial statements.
- A receivable of $200,000 from Ward Corporation for merchandise sales on credit. Ward is a 90% owned, unconsolidated subsidiary of Cobb.

In the current assets section of its December 31, 1985, consolidated balance sheet, Cobb should report accounts receivable from investees in the total amount of
a. $180,000
b. $255,000
c. $275,000
d. $355,000

1N85#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

1N85#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
Selected Questions

1M85#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

1M85#5. An analysis and aging of the accounts receivable of Grey Company at December 31, 1984, revealed the following data:

| Accounts receivable $900,000 | Allowance for uncollectible accounts per books 50,000 | Amounts deemed uncollectible 64,000 |

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:

<table>
<thead>
<tr>
<th>Present value of an annuity due of $1 at 10% for 6 periods</th>
<th>4.791</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of an annuity due of $1 at 10% for 8 periods</td>
<td>5.868</td>
</tr>
</tbody>
</table>

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. $30,000
- 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

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

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

1N83#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 re-
ceivable 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

1N83#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

C. Inventories

1M87#16. Evan Company adopted the dollar value LIFO inventory method on December 31, 1985. Evan's entire inventory constitutes a single pool. On December 31, 1985, the inventory was $300,000 under the dollar value LIFO method. Inventory data for 1986 are as follows:

| 12/31/86 inventory at year-end prices | $390,000 |
| Relevant price index at year-end (base year 1985) | 120 |

Using dollar value LIFO, Evan's inventory at December 31, 1986, is

a. $325,000  
b. $330,000  
c. $360,000  
d. $390,000

1M87#17. On July 1, 1986, Link Development Company purchased a tract of land for $900,000. Additional costs of $150,000 were incurred in subdividing the land during July through December 1986. Of the tract acreage, 70% was subdivided into residential lots as shown below and 30% was conveyed to the city for roads and a park.

<table>
<thead>
<tr>
<th>Lot class</th>
<th>Number of lots</th>
<th>Sales price per lot</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>100</td>
<td>$12,000</td>
</tr>
<tr>
<td>B</td>
<td>100</td>
<td>8,000</td>
</tr>
<tr>
<td>C</td>
<td>200</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Under the relative sales value method, the cost allocated to each Class A lot should be

a. $2,625  
b. $2,940

c. $3,600  
d. $4,200

2N86#1. The following information pertains to an item in Bay Co.'s inventory at year end:

<table>
<thead>
<tr>
<th>Cost</th>
<th>$1.50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Replacement cost</td>
<td>.60</td>
</tr>
<tr>
<td>Net realizable value</td>
<td>1.20</td>
</tr>
<tr>
<td>Net realizable value less normal profit</td>
<td>.84</td>
</tr>
</tbody>
</table>

Under the lower of cost or market approach, how much is the year-end inventory value of this item?

a. $1.20  
b. $ .84  
c. $ .66  
d. $ .60

2N86#5. At December 31, 1985, the following information was available from Palo Co.'s accounting records:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/85</td>
<td>$ 73,500</td>
</tr>
<tr>
<td>Purchases</td>
<td>416,500</td>
</tr>
<tr>
<td>Additional markups</td>
<td>—</td>
</tr>
<tr>
<td>Available for sale</td>
<td>$490,000</td>
</tr>
</tbody>
</table>

Sales for the year totaled $553,000; markdowns amounted to $7,000. Under the approximate lower of average cost or market retail method, Palo's inventory at December 31, 1985, was

a. $ 98,000  
b. $107,800  
c. $140,000  
d. $154,000

2N86#13. Day Retailers purchased merchandise with a list price of $10,000, subject to trade discounts of 20% and 10%, with no cash discounts allowable. How much should Day record as the cost of this merchandise?

a. $10,000  
b. $7,800  
c. $7,200  
d. $7,000

1M86#4. Dean Sportswear, Inc., regularly buys sweaters from Mill Company and is allowed a trade discount of 30% from the list price. Dean made a purchase on March 20, 1986, and received an invoice with a list price of $6,000, a freight charge of $150, and payment terms of net 30 days. Dean should record the purchase at

a. $4,200  
b. $4,350  
c. $6,000  
d. $6,150
**Selected Questions**

**1N85#10.** Frey Company recorded the following data pertaining to raw material Y during January 1986:

<table>
<thead>
<tr>
<th>Date</th>
<th>Received</th>
<th>Cost</th>
<th>Issued</th>
<th>On hand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/86</td>
<td></td>
<td>2.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/8/86</td>
<td></td>
<td></td>
<td></td>
<td>800</td>
</tr>
<tr>
<td>1/20/86</td>
<td></td>
<td>400</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>1/1/86</td>
<td>1,200</td>
<td>2.40</td>
<td></td>
<td>1,600</td>
</tr>
</tbody>
</table>

The moving-average unit cost of Y inventory at January 31, 1986, is
a. $2.20
b. $2.24
c. $2.30
d. $2.40

**1N85#12.** On December 31, 1984, Jason Company adopted the dollar value LIFO retail inventory method. Inventory data for 1985 are as follows:

<table>
<thead>
<tr>
<th>LIFO cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>360,000</td>
<td>500,000</td>
</tr>
<tr>
<td>?</td>
<td>660,000</td>
</tr>
</tbody>
</table>

Increase in price level for 1985 is 10%.
Cost to retail ratio for 1985 is 70%.

Under the LIFO retail method, Jason's inventory at December 31, 1985, should be
a. $437,000
b. $462,000
c. $472,000
d. $483,200

**1N85#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

**1N85#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 inventoriable cost for 1984 was
a. $600,000
b. $603,000
c. $612,000
d. $618,000

**1N85#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>40,000</td>
</tr>
<tr>
<td>Markdowns</td>
<td>160,000</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

**1N85#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

**1N85#10.** Marsh Company had 150 units of product A on hand at January 1, 1983, costing $21 each. Pur-
chases 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

Dalton Company adopted the dollar value LIFO inventory method on January 1, 1983. In applying the LIFO method Dalton uses internal price indexes 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 index</th>
</tr>
</thead>
<tbody>
<tr>
<td>At current year cost</td>
<td>At base year cost</td>
</tr>
<tr>
<td>1/1/83</td>
<td>$100,000</td>
</tr>
<tr>
<td>12/31/83</td>
<td>126,000</td>
</tr>
<tr>
<td>12/31/84</td>
<td>140,800</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

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

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

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

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
Selected Questions

1M84#7. At December 31, 1983, the following data pertain to an inventory item held by Bradley Distribution Company:

- Estimated selling price: $78
- Normal profit margin: 15
- Estimated cost of disposal: 2
- Cost: 65
- Replacement cost: 57

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

a. $57  
b. $61  
c. $63  
d. $65

1N83#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

D. Property, Plant, and Equipment Owned or Leased

1M87#7. On December 1, 1986, Terry Company signed a 10-year nonrenewable lease for a building to be used in its manufacturing operations. During the latter part of December 1986 Terry incurred the following costs:

- $96,000 for general improvements to the premises.
- $48,000 for movable assembly line equipment.
- $120,000 for office furniture and equipment.

In its December 31, 1986 balance sheet, Terry should report leasehold improvements of

- a. $96,000  
- b. $144,000  
- c. $216,000  
- d. $264,000

1M87#8. On January 1, 1986, Huff Company owned a machine having a carrying amount of $240,000. The machine was purchased four years earlier for $400,000. Huff uses straight-line depreciation. During December 1986 Huff determined that the machine suffered permanent impairment of its operational value and will not be economically useful in its production process after December 31, 1986. Huff sold the machine for $65,000 on January 5, 1987. In its income statement for the year ended December 31, 1986, Huff should recognize a loss of

- a. $200,000  
- b. $175,000  
- c. $135,000  
- d. $0

1M87#9. On June 30, 1986, a fire in Pine Company's plant caused a total loss to a production machine. The machine was being depreciated at $20,000 annually and had a carrying amount of $160,000 at December 31, 1985. On the date of the fire the fair value of the machine was $220,000, and Pine received insurance proceeds of $200,000 in October 1986. In its income statement for the year ended December 31, 1986, what amount should Pine recognize as a gain or loss on disposition?

- a. $0  
- b. $20,000 loss  
- c. $40,000 gain  
- d. $50,000 gain

1N86#2. On January 2, 1986, Conn Company replaced its old high-pressure steam boiler with a more efficient oil-burning boiler. The following information was available on that date:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of old boiler</td>
<td>$4,000</td>
</tr>
<tr>
<td>Fair value of old boiler</td>
<td>$1,000</td>
</tr>
<tr>
<td>Purchase and installation price of the new boiler</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
The old boiler was sold to a heating contractor for $1,000. How much should Conn capitalize as the cost of the new boiler?
   a. $50,000
   b. $49,000
   c. $47,000
   d. $46,000

1N86#3. On June 30, 1986, Kent Company completed the rearrangement of a group of factory machines to secure greater efficiency in production. Kent estimated that benefits from the rearrangement would extend over the remaining five-year useful lives of the machines. The following costs were incurred:

   Moving                        $35,000
   Reinstallation                75,000
   Annual maintenance
     (performed at this time for convenience) 10,000

How much of the costs incurred should be capitalized on June 30, 1986?
   a. $0
   b. $ 75,000
   c. $110,000
   d. $120,000

2N86#2. Saba Co. bought a tract of land, paying $800,000 in cash and assuming an existing mortgage of $200,000. The municipal tax bill disclosed an assessed valuation of $700,000. How much should Saba record as an asset for this land acquisition?
   a. $600,000
   b. $700,000
   c. $800,000
   d. $1,000,000

Items 7 through 10 are based on the following data:

When Key Co. commenced business operations on January 1, 1983, the following assets were among those acquired at that date:

\textit{Real estate}

\begin{itemize}
   \item Cost of parcel of land \hspace{1cm} $20,000
   \item Cost of razing old structure which had been on the land \hspace{1cm} 3,000
   \item Title insurance and legal fees pertaining to land acquisition \hspace{1cm} 5,000
   \item Architect's fees \hspace{1cm} 30,000
   \item Cost of constructing new building \hspace{1cm} 600,000
\end{itemize}

\textit{Machinery}

\begin{itemize}
   \item Cost \hspace{1cm} 100,000
   \item Residual value \hspace{1cm} 10,000
   \item Estimated useful life (double-declining-balance method) \hspace{1cm} 4 years
\end{itemize}

In 1985, Key incurred the following losses:

\begin{itemize}
   \item Foreign exchange loss because of major devaluation of foreign currency \hspace{1cm} $17,000
   \item Effects of a strike against Key's major supplier \hspace{1cm} 120,000
\end{itemize}

Also during 1985, the following gains were recognized:

\begin{itemize}
   \item Income tax benefit arising from operating loss carryforward \hspace{1cm} $80,000
   \item Gain on sale of real estate used in operations \hspace{1cm} 300,000
\end{itemize}

7. How much should Key have capitalized in 1983 as the cost of the new building?
   a. $600,000
   b. $630,000
   c. $635,000
   d. $638,000

8. At December 31, 1984, after Key's second year of operations, how much was the accumulated depreciation on the machinery?
   a. $45,000
   b. $50,000
   c. $67,500
   d. $75,000

1M86#13. On March 1, 1985, Lake Company purchased a tract of land as a factory site for $350,000. An existing building on the property was razed and construction was begun on a new factory building in April 1985. Additional data are available as follows:

\begin{itemize}
   \item Cost of razing old building \hspace{1cm} $50,000
   \item Title insurance and legal fees to purchase land \hspace{1cm} 25,000
   \item Architect's fees \hspace{1cm} 85,000
   \item New building construction cost \hspace{1cm} 1,750,000
\end{itemize}

The capitalized cost of the completed factory building should be
   a. $1,800,000
   b. $1,835,000
   c. $1,860,000
   d. $1,885,000

1M86#15. On January 2, 1983, Wayne, Inc., signed an eight-year lease for office space. Wayne has the option to renew the lease for an additional four-year period on or before January 2, 1990. During January 1985, two years after occupying the leased premises, Wayne made general improvements to the premises costing $360,000 and having an estimated useful life of ten years. At December 31, 1985, Wayne's intentions as to exercise of the renewal option are uncertain because they depend upon future office space require-
ments. A full year’s amortization expense is taken for calendar year 1985. Wayne should record amortization of leasehold improvements for 1985 at
a. $30,000  

b. $36,000  

c. $45,000  

d. $60,000  

1N85#16. During 1985 King Company made the following expenditures relating to its plant building:

Continuing and frequent repairs $40,000  
Repainted the plant building 10,000  
Major improvements to the electrical wiring system 32,000  
Partial replacement of roof tiles 14,000  

How much should be charged to repair and maintenance expense in 1985?

a. $96,000  
b. $82,000  
c. $64,000  
d. $54,000  

1N85#17. On January 1, 1982, Green Company purchased a machine for $800,000 and established an annual depreciation charge of $100,000 over an eight-year life. During 1985, after issuance of the 1984 financial statements, Green concluded that: (1) the machine suffered permanent impairment of its operational value, and (2) $200,000 is a reasonable estimate of the amount expected to be recovered through use of the machine for the period January 1, 1985, to December 31, 1989. In Green’s December 31, 1985, balance sheet, the machine should be reported at a carrying amount of

a. $0  
b. $100,000  
c. $160,000  
d. $400,000  

1N85#19. On September 10, 1985, Landy Company incurred the following costs for one of its printing presses:

Purchase of stapling attachment $45,000  
Installation of attachment 10,000  
Replacement parts for renovation of press 30,000  
Labor and overhead in connection with renovation of press 14,000  

Neither the attachment nor the renovation increased the estimated useful life of the press. However, the renovation resulted in significantly increased productivity. What amount of the costs should be capitalized?

a. $0  
b. $44,000  
c. $55,000  
d. $99,000  

1N85#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  

1N85#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>
</tbody>
</table>

Town should record the land at

a. $140,000  
b. $180,000  
c. $200,000  
d. $216,000  

1N85#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  

1N85#15. On January 2, 1984, Terry Company signed a ten-year noncancellable 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
Accounting Practice

1N85#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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building — at book value</td>
<td>$260,000</td>
</tr>
<tr>
<td>Building — at fair value</td>
<td>$275,000</td>
</tr>
<tr>
<td>Removal and clean-up cost</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

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

1N85#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. $94,000  
c. $70,000  
d. $60,000

1N85#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. $90  
b. $1,130,000  
c. $1,229,000  
d. $2,000,000

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

AP-16
1M84#15. On June 1, 1984, Ichor Company entered into a ten-year non-cancellable 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

1M84#16. On January 3, 1983, Sutter Company signed a ten-year non-cancellable 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

1M84#20. 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

1M84#5. During 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

1M84#3. 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

1M84#9. 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

1M84#10. The following expenditures relating to the plant building were made by Pine Company during the year ended December 31, 1983:

   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

1NB4#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

1NB4#14. Hines Company leased a new machine from Ashwood Company on December 31, 1982, under a lease with the following pertinent information:

<table>
<thead>
<tr>
<th>Depletion expense</th>
<th>Loss on abandonment</th>
</tr>
</thead>
<tbody>
<tr>
<td>$18,000 and a coinsurance clause of 80%. How much should Hadley expect to recover from the insurance company?</td>
<td></td>
</tr>
<tr>
<td>a. $24,000</td>
<td></td>
</tr>
<tr>
<td>b. $22,500</td>
<td></td>
</tr>
<tr>
<td>c. $18,000</td>
<td></td>
</tr>
<tr>
<td>d. $14,400</td>
<td></td>
</tr>
</tbody>
</table>

1NB3#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.

1NB3#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?

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

1NB3#28. Barker Company leased a new machine from Bell Company on July 1, 1983, under a lease with the following pertinent information:

<table>
<thead>
<tr>
<th>Lease term</th>
<th>10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual rental payable at the beginning of each lease year</td>
<td>$30,000</td>
</tr>
<tr>
<td>Useful life of the machine</td>
<td>12 years</td>
</tr>
<tr>
<td>Implicit interest rate</td>
<td>14%</td>
</tr>
<tr>
<td>Present value of an annuity of $1 in advance for 10 periods at 14%</td>
<td>5.95</td>
</tr>
<tr>
<td>Present value of $1 for 10 periods at 14%</td>
<td>0.27</td>
</tr>
</tbody>
</table>

AP-18
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

- $150,000
- $178,500
- $189,300
- $190,000

1M83#35. Crowder Company acquired a tract of land containing an extractable natural resource. Crowder is required to 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:

<table>
<thead>
<tr>
<th>Land</th>
<th>Estimated restoration costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>$9,000,000</td>
<td>1,500,000</td>
</tr>
</tbody>
</table>

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

- $2.10
- $1.90
- $1.80
- $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?

- $ 6,400
- $ 8,000
- $ 9,600
- $12,000

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?

- $0
- $50,000
- $450,000
- $1,100,000

Items 21 and 22 are based on the following information:

- 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.


- $0
- $6,610
- $7,000
- $10,000

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

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase of collating and</td>
<td>$42,000</td>
</tr>
<tr>
<td>stapling attachment</td>
<td></td>
</tr>
<tr>
<td>Installation of attachment</td>
<td>$18,000</td>
</tr>
<tr>
<td>Replacement parts for overhaul</td>
<td></td>
</tr>
<tr>
<td>of press</td>
<td>$13,000</td>
</tr>
<tr>
<td>Labor and overhead in connection</td>
<td></td>
</tr>
<tr>
<td>with overhaul</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>Total</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

AP-19
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. $55,000
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></td>
<td>$225,000</td>
<td>$133,600</td>
<td></td>
<td>$44,000</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.

31. Forst deprecates asset A on the double-declining-balance method. How much depreciation expense should Forst record in 1982 for asset A?
   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 Forst record in 1982 for asset B?
   a. $6,000
   b. $9,000
   c. $11,000
   d. $12,000

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

E. Intangibles and Other Assets

1M87#10. On July 1, 1986, Hart signed an agreement to operate as a franchisee of Ace Printers for an initial franchise fee of $120,000. The same date, Hart paid $40,000 and agreed to pay the balance in four equal annual payments of $20,000 beginning July 1, 1987. The down payment is not refundable and no future services are required of the franchisor. Hart can borrow at 14% for a loan of this type. Present and future value factors are as follows:

Present value of 1 at 14% for 4 periods = 0.59
Future amount of 1 at 14% for 4 periods = 1.69
Present value of an ordinary annuity of 1 at 14% for 4 periods = 2.91

Hart should record the acquisition cost of the franchise on July 1, 1986, at
   a. $135,200
   b. $120,000
   c. $98,200
   d. $87,200

1N86#1. Ott Company acquired rights to a patent from Grey under a licensing agreement that required an advance royalty payment when the agreement was signed. Ott remits royalties earned and due under the agreement on October 31 each year. Additionally, on the same date, Ott pays, in advance, estimated royalties for the next year. Ott adjusts prepaid royalties at year end. Information for the year ended December 31, 1985, is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/85</td>
<td>$ 65,000</td>
</tr>
<tr>
<td>10/31/85</td>
<td>Royalty payment (charged to royalty expense) $110,000</td>
</tr>
<tr>
<td>12/31/85</td>
<td>Year-end credit adjustment to royalty expense $25,000</td>
</tr>
</tbody>
</table>

In its December 31, 1985, balance sheet, Ott should report prepaid royalties of
   a. $25,000
   b. $40,000
   c. $85,000
   d. $90,000

1N86#5. On April 30, 1986, Star, Inc., purchased for $30 per share all 200,000 of Wren Corp.'s outstanding common stock. On this date Wren's balance sheet
showed net assets of $5,000,000. Additionally, the fair value of Wren’s identifiable assets on this date was $600,000 in excess of their carrying amount. In Star’s April 30, 1986, consolidated balance sheet, what amount should be reported as goodwill?

   a. $0
   b. $ 400,000
   c. $ 600,000
   d. $1,000,000

1M86#8. For the year ended December 31, 1985, Rapp, Inc., reported royalty income of $450,000 in its income statement. Royalties received, reported as taxable income, amounted to $700,000 for 1985. Also in 1985, Rapp paid $175,000 of premiums on officers’ life insurance, on which Rapp is the beneficiary. Rapp’s income tax rate is 40% for 1985. By what amount would the asset, deferred income tax, account increase for 1985?

   a. $100,000
   b. $150,000
   c. $170,000
   d. $255,000

1M86#11. On December 31, 1985, Wall Company signed an agreement to operate as a franchisee of Fast Food, Inc., for an initial franchise fee of $80,000. Of this amount, $30,000 was paid when the agreement was signed and the balance is payable in five annual payments of $10,000 each beginning December 31, 1986. The present value of the five payments, at an appropriate rate of interest, is $36,000 at December 31, 1985. The agreement provides that the down payment is not refundable and no future services are required of the franchisor. Wall should report the franchise in its December 31, 1985, balance sheet at

   a. $80,000
   b. $66,000
   c. $30,000
   d. $0

1M86#14. Under Hart Company’s accounting system, all insurance premiums paid are debited to prepaid insurance. For interim financial reports, Hart makes monthly estimated charges to insurance expense with credits to prepaid insurance. Additional information for the year ended December 31, 1985, is as follows:

| Prepaid insurance at December 31, 1984 | $210,000 |
| Charges to insurance expense during 1985 (including a year-end adjustment of $35,000) | 875,000 |
| Unexpired insurance premiums at December 31, 1985 | 245,000 |

What was the total amount of insurance premiums paid by Hart during 1985?

   a. $910,000
   b. $875,000
   c. $840,000
   d. $665,000

1M86#18. On January 1, 1981, Vick Company purchased a trademark for $400,000, having an estimated useful life of 16 years. In January 1985, Vick paid $60,000 for legal fees in a successful defense of the trademark. Trademark amortization expense for the year ended December 31, 1985, should be

   a. $0
   b. $25,000
   c. $28,750
   d. $30,000

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 accounted 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>Book value</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$160,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>180,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>290,000</td>
</tr>
<tr>
<td>Property, plant &amp; equipment</td>
<td>870,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(350,000)</td>
</tr>
<tr>
<td>Net worth</td>
<td>$1,150,000</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

1M85#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 |

| Total | $105,000 |

AP-21
Accounting Practice

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#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. $2,250

1N84#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 account balance increase for 1983?

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

1N83#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 $350,000 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:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$160,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>480,000</td>
</tr>
<tr>
<td>Property, plant and equipment (net)</td>
<td>960,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(360,000)</td>
</tr>
</tbody>
</table>

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
A. Payables and Accruals

1M87#5. On December 30, 1986, Case Company purchased a machine from Pitt in exchange for a non-interest bearing note requiring ten payments of $10,000. The first payment was made on December 30, 1986, and the others are due annually on December 30. The prevailing rate of interest for this type of note at date of issuance was 10%. Present value factors are as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Present value of ordinary annuity of $1 at 10%</th>
<th>Present value of annuity in advance of $1 at 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>5.759</td>
<td>6.335</td>
</tr>
<tr>
<td>10</td>
<td>6.145</td>
<td>6.759</td>
</tr>
</tbody>
</table>

At December 31, 1986, the total note payable to Pitt was
a. $67,590
b. $63,350
c. $61,450
d. $57,590

1M87#11. Bain Company salaried employees are paid biweekly. Occasionally, advances made to employees are paid back by payroll deductions. Information relating to salaries for the calendar year 1986 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>12/31/85</th>
<th>12/31/86</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee advances</td>
<td>$12,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>Accrued salaries payable</td>
<td>65,000</td>
<td>?</td>
</tr>
<tr>
<td>Salaries expense during the year</td>
<td>815,000</td>
<td></td>
</tr>
<tr>
<td>Salaries paid during the year (gross)</td>
<td>780,000</td>
<td></td>
</tr>
</tbody>
</table>

At December 31, 1986, what amount should Bain report for accrued salaries payable?

a. $100,000
b. $94,000
c. $82,000
d. $35,000

1M87#15. Cey Company has a defined benefit pension plan. Cey’s policy is to fund net periodic pension cost annually, payment to an independent trustee being made two months after the end of each year. Data relating to the pension plan for 1986 are as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net pension cost for 1986</td>
<td>$190,000</td>
</tr>
<tr>
<td>Unrecognized prior service cost, 12/31/86</td>
<td>150,000</td>
</tr>
<tr>
<td>Accumulated benefit obligation, 12/31/86</td>
<td>480,000</td>
</tr>
<tr>
<td>Fair value of plan assets, 12/31/86</td>
<td>500,000</td>
</tr>
</tbody>
</table>

How much should appear on Cey’s balance sheet at December 31, 1986, for pension liability?

<table>
<thead>
<tr>
<th>Current</th>
<th>Noncurrent</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$480,000</td>
</tr>
<tr>
<td>b. $0</td>
<td>$330,000</td>
</tr>
<tr>
<td>c. $190,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>d. $190,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

1N86#4. Bell Company’s current liabilities at December 31, 1985, totaled $1,000,000 before any necessary year-end adjustment relating to the following:

- During December 1985 Bell received $50,000 from Fox, a customer, as an advance payment for a packaging machine which Bell will construct to Fox’s specifications. From this transaction, Bell has a $50,000 credit balance in its account receivable from Fox at December 31, 1985.
- On December 27, 1985, Bell wrote and recorded checks to creditors totaling $400,000 which would cause an overdraft of $100,000 in Bell’s bank account at December 31, 1985. The checks were mailed out on January 10, 1986.

At December 31, 1985, what amount should Bell report as total current liabilities?

a. $1,050,000
b. $1,150,000
c. $1,400,000
d. $1,450,000

1N86#6. Dean, Inc., has $2,000,000 of notes payable due June 15, 1986. At the financial statement date of December 31, 1985, Dean signed an agreement to borrow up to $2,000,000 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 collateral Dean was providing. At the date of issue of the December 31, 1985, financial statements, the value of the collateral was $2,400,000 and was not expected to fall below this amount during 1986. In its December 31, 1985, balance sheet, Dean should classify notes payable as

<table>
<thead>
<tr>
<th>Short-term obligations</th>
<th>Long-term obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $2,000,000</td>
<td>$0</td>
</tr>
<tr>
<td>b. $400,000</td>
<td>$1,600,000</td>
</tr>
<tr>
<td>c. $80,000</td>
<td>$1,920,000</td>
</tr>
<tr>
<td>d. $0</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

1N86#7. During 1985 Mann Company experienced financial difficulties and is likely to default on a $500,000, 15%, three-year note dated January 1, 1984, payable to Summit Bank. On December 31, 1985, the bank
agreed to settle the note and unpaid interest of $75,000 for 1985 for $410,000 cash payable on January 31, 1986. Ignoring income taxes, what amount should Mann report as a gain from the debt restructuring in its 1985 income statement?

a. $165,000  
b. $90,000  
c. $75,000  
d. $0

**1M86#8.** Included in King Corporation's liability account balances at December 31, 1984, was a note payable in the amount of $2,400,000. The note is dated October 1, 1984, bears interest at 15%, and is payable in three equal annual payments of $800,000. The first interest and principal payment was made on October 1, 1985. In its December 31, 1985, balance sheet, what amount should King report as accrued interest payable for this note?

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

**1M86#9.** For the year ended December 31, 1985, Hurd, Inc., reported book income of $900,000 before income taxes. Selected information for 1985 is available from Hurd's records as follows:

Interest income on municipal bonds $70,000
Depreciation claimed on tax return in excess of depreciation per books $130,000
Warranty expense on the accrual basis $60,000
Actual warranty expenditures $35,000

Hurd's income tax rate is 40% for 1985. Hurd's current liability for 1985 income taxes (before reduction for estimated taxes paid) should be

a. $280,000  
b. $290,000  
c. $332,000  
d. $360,000

**1M86#10.** West Company determined that it has an obligation relating to employees' rights to receive compensation for future absences attributable to employees' services already rendered. The obligation relates to rights that vest, and payment of the compensation is probable. The amounts of West's obligations as of December 31, 1985, are reasonably estimated as follows:

Vacation pay $110,000  
Sick pay 80,000

In its December 31, 1985, balance sheet, what amount should West report as its liability for compensated absences?

a. $0  
b. $80,000  
c. $110,000  
d. $190,000

**1M86#22.** The balance in Ott Company's accounts payable account at December 31, 1985, was $1,100,000 before considering the following information:

- Goods shipped F.O.B. shipping point on December 20, 1985, from a vendor to Ott were lost in transit. The invoice cost of $20,000 was not recorded by Ott. On January 6, 1986, Ott filed a $20,000 claim against the common carrier.
- On December 27, 1985, a vendor authorized Ott to return, for full credit, goods shipped and billed at $35,000 on December 2, 1985. The returned goods were shipped by Ott on December 27, 1985. A $35,000 credit memo was received and recorded by Ott on January 6, 1986.

What amount should Ott report as accounts payable in its December 31, 1985, balance sheet?

a. $1,065,000  
b. $1,085,000  
c. $1,115,000  
d. $1,120,000

**1M86#23.** Dix Company operates a retail store and must determine the proper December 31, 1985, year-end accrual for the following expenses:

- The store lease calls for fixed rent of $1,200 per month, payable at the beginning of the month, and additional rent equal to 6% of net sales over $250,000 per calendar year, payable on January 31 of the following year. Net sales for 1985 are $450,000.
- An electric bill of $850 covering the period 12/16/85 through 1/15/86 was received January 22, 1986.
- A $400 telephone bill was received January 7, 1986, covering:

<table>
<thead>
<tr>
<th>Service in advance for January 1986</th>
<th>Local and toll calls for December 1985</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>$150</td>
<td>250</td>
</tr>
</tbody>
</table>

In its December 31, 1985, balance sheet, Dix should report accrued liabilities of

a. $15,075  
b. $13,100  
c. $12,825  
d. $12,675
Selected Questions

1M86#25. The books of Apex, Inc., for the year ended December 31, 1985, showed income of $720,000 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 $32,000
Income from installment sale reportable for tax purposes in excess of income recognized on the books 24,000

Assuming a corporate income tax rate of 40%, what should Apex record as its current federal income tax liability at December 31, 1985?

a. $291,200
b. $288,000
c. $284,800
d. $275,200

1M86#26. Farr 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. Farr accounts for the containers not returned within the time limit as being retired by sale at the deposit amount. Information for 1985 is as follows:

Containers held by customers at December 31, 1984, from deliveries in:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>$75,000</td>
</tr>
<tr>
<td>1984</td>
<td>$215,000</td>
</tr>
</tbody>
</table>

Containers delivered in 1985: 390,000
Containers returned in 1985 from deliveries in:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>$45,000</td>
</tr>
<tr>
<td>1984</td>
<td>$125,000</td>
</tr>
<tr>
<td>1985</td>
<td>$143,000</td>
</tr>
</tbody>
</table>

What amount should Farr report as a liability for returnable containers at December 31, 1985?

a. $247,000
b. $322,000
c. $337,000
d. $367,000

1M85#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 noncancellable 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

1N85#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
1N85#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</th>
<th>Maturities</th>
</tr>
</thead>
<tbody>
<tr>
<td>payments</td>
<td></td>
</tr>
<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

2N85#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 prepayment 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

2N85#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

2N85#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#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>Year after sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>4%</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>Warranty Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982 $500,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>1983 $700,000</td>
<td>$47,000</td>
</tr>
<tr>
<td><strong>$1,200,000</strong></td>
<td><strong>$62,000</strong></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.
Selected Questions

- 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

1M83#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 restructuring in its 1982 income statement?
  a. $ 65,000
  b. $ 75,000
  c. $140,000
  d. $150,000

2N83#3. All of Rolf Co.'s employees are entitled to two weeks of paid vacation for each full year in Rolf's employ. Unused vacation time can be accumulated and carried forward to succeeding years, and will be compensated at the salary in effect when the vacation is taken. Mary Beal started her employment with Rolf on January 1, 1976. As of December 31, 1982, when Beal's salary was $500 per week, Beal had used ten weeks of her accumulated vacation time. In December 1982, Beal notified Rolf of Beal's intention to use her accumulated vacation weeks in June 1983. Rolf regularly scheduled salary adjustments in July of each year. Rolf properly did not deduct compensation for unused vacations in Rolf's 1982 income tax return. How much should Rolf report as a liability at December 31, 1982, for Beal's accumulated vacation time?
  a. $0
  b. $500
  c. $1,000
  d. $2,000

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 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:

<table>
<thead>
<tr>
<th>Benefit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vacation pay</td>
<td>$100,000</td>
</tr>
<tr>
<td>Holiday pay</td>
<td>25,000</td>
</tr>
</tbody>
</table>

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

B. Deferred Revenues

1M87#13. Kent Company sells magazine subscriptions for one to three-year periods. 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, 1986 before year-end adjustment. Outstanding subscriptions at December 31, 1986, expire as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>$600,000</td>
</tr>
<tr>
<td>1988</td>
<td>900,000</td>
</tr>
<tr>
<td>1989</td>
<td>400,000</td>
</tr>
</tbody>
</table>

In its December 31, 1986 balance sheet, what amount should Kent report as the balance for magazine subscriptions collected in advance?
  a. $ 500,000
  b. $1,200,000
  c. $1,900,000
  d. $2,400,000

1M87#14. On December 31, 1986, Reed, Inc., authorized Foy to operate as a franchisee for an initial
franchise fee of $75,000. Of this amount, $30,000 was received upon signing the agreement and the balance, represented by a note, is due in three annual payments of $15,000 each beginning December 31, 1987. The present value on December 31, 1986, of the three annual payments appropriately discounted is $36,000. According to the agreement, the nonrefundable down payment represents a fair measure of the services already performed by Reed; however, substantial future services are required of Reed. Collectibility of the note is reasonably certain. On December 31, 1986, Reed should record unearned franchise fees in respect of the Foy franchise of
a. $0
b. $36,000
c. $45,000
d. $75,000

1N86#13. East Company began operations on January 1, 1985, and uses the installment method of accounting for income tax reporting. The following information pertains to East’s operations for 1985:

Installment sales $800,000
Installment accounts receivable, 12/31/85 500,000
Gross profit on sales 40%

For income tax purposes, East should report deferred gross profit at December 31, 1985, of
a. $120,000
b. $200,000
c. $300,000
d. $320,000

1N86#14. On December 31, 1985, Pell, Inc., sold a machine to Flax, and simultaneously leased it back for one year. Pertinent information at this date is as follows:

Sales price $360,000
Carrying amount 315,000
Estimated remaining useful life 12 years
Present value of lease rentals ($3,000 for 12 months @12%) 34,100

At December 31, 1985, how much should Pell report as deferred revenue from the sale of the machine?

a. $0
b. $10,900
c. $34,100
d. $45,000

2M86#15. Cone Co., which began operating on January 1, 1985, appropriately uses the installment method of accounting. The following information pertains to Cone’s operations for the year 1985:

Installment sales $500,000
Cost of installment sales 300,000
General and administrative expenses 50,000
Collections on installment sales 100,000

The balance in the deferred gross profit account at December 31, 1985, should be
a. $200,000
b. $160,000
c. $120,000
d. $100,000

Accounting Practice

In its December 31, 1985, balance sheet, what amount should Beal report as unearned service contract revenue?

a. $390,000
b. $510,000
c. $640,000
d. $750,000

1M87#18. At December 31, 1986, Arno Beauticians had 1,000 gift certificates outstanding which had been sold to customers during 1986 for $75 each. Arno operates on a gross margin of 60%. How much revenue pertaining to the 1,000 outstanding gift certificates should be deferred at December 31, 1986?

a. $0
b. $30,000
c. $45,000
d. $75,000

1N86#11. Cobb Department Store sells gift certificates redeemable only when merchandise is purchased. These gift certificates have an expiration date of two years after issuance date. Upon redemption or expiration, Cobb recognizes the unearned revenue as realized. Information for 1985 is as follows:

Unearned revenue, 1/1/85 $ 65,000
Gift certificates sold 225,000
Gift certificates redeemed 195,000
Expired gift certificates 10,000
Cost of goods sold 60%

In its December 31, 1985, balance sheet, what amount should Cobb report as unearned revenue?

a. $51,000
b. $57,000
c. $85,000
d. $95,000

1N86#12. Beal Company sells contracts agreeing to service equipment for a three-year period. Information for the year ended December 31, 1985, is as follows:

Cash receipts from service contracts sold $960,000
Service contract revenue recognized 780,000
Uncollected service contract revenue, 1/1/85 570,000
1N85#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:

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>During 1985</td>
<td>$450,000</td>
</tr>
<tr>
<td>During 1986</td>
<td>350,000</td>
</tr>
<tr>
<td>During 1987</td>
<td>275,000</td>
</tr>
</tbody>
</table>

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

1N85#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:

- Cash receipts from subscribers: $2,300,000
- Magazine subscriptions revenue: 1,600,000

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

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

1M84#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

1N83#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

1M83#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

AP-29
C. Deferred Income Tax Liabilities

1M87#23. On January 1, 1986, Ward Corporation purchased a press for $90,000, which will be depreciated $9,000 per year for financial statement reporting. For income tax reporting, Ward uses the ACRS and will be allowed a cost recovery deduction of $13,500 for 1986. Assuming an income tax rate of 40%, how much deferred income tax should be added to Ward’s deferred income tax liability at December 31, 1986?
   a. $0
   b. $1,800
   c. $2,700
   d. $5,400

1M87#24. Mill, Inc., which began operations on January 1, 1984, recognizes income from construction-type contracts under the percentage-of-completion method in its financial statements but uses the completed-contract method for income tax reporting. Reported income from construction-type 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>1984</td>
<td>800,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>1985</td>
<td>1,300,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>1986</td>
<td>1,900,000</td>
<td>1,500,000</td>
</tr>
</tbody>
</table>

For all years the income tax rate is 40%, and there are no other timing differences. At December 31, 1986, Mill should report a liability for deferred taxes of
   a. $720,000
   b. $400,000
   c. $320,000
   d. $160,000

1N86#16. Reade Corporation owns 30% of the voting common stock of Bixby, Inc., and appropriately accounts for its investment by the equity method. During 1985 Bixby reported earnings of $450,000 and paid dividends of $150,000. Reade assumes that all of Bixby’s undistributed earnings will be distributed as dividends in future periods. Ignore the dividend-received deduction. Reade’s income tax rate is 40%. The amount of deferred income tax to be reported by Reade for 1985 is
   a. $0
   b. $18,000
   c. $36,000
   d. $54,000

1N86#17. On December 2, 1985, Dall Corporation received a condemnation award of $450,000 as compensation for the forced sale of land purchased five years earlier for $300,000. The $150,000 gain was not reported as taxable income on its income tax return for the year ended December 31, 1985, because Dall elected to replace the land within the allowed replacement period. Dall has an income tax rate of 40% for 1985. In its December 31, 1985, balance sheet, this gain will cause Dall to report a deferred income tax credit of
   a. $0
   b. $60,000
   c. $90,000
   d. $120,000

1M86#28. Mill Company began operations on January 1, 1983, and recognizes income from construction-type contracts under the percentage-of-completion method for financial reporting. However, on its income tax returns, Mill reports revenues under the completed-contract method. Information concerning income recognition 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>1983</td>
<td>400,000</td>
<td>$0</td>
</tr>
<tr>
<td>1984</td>
<td>625,000</td>
<td>375,000</td>
</tr>
<tr>
<td>1985</td>
<td>750,000</td>
<td>850,000</td>
</tr>
</tbody>
</table>

For all years, assume the income tax rate is 40% and there are no other timing differences. In its December 31, 1985, balance sheet, Mill should report deferred income taxes of
   a. $0
   b. $220,000
   c. $260,000
   d. $330,000

2M86#16. Dina, Inc., owns 75% of the voting common stock of its domestic subsidiary, Spruce Corp. During 1985, Spruce had earnings of $300,000, and paid dividends of $100,000. Dina assumes that Spruce’s remaining earnings will be distributed as dividends in future periods. Dina’s income tax rate is 40%. For 1985, how much should Dina report as deferred income tax?
   a. $90,000
   b. $13,500
   c. $9,000
   d. $0

2M86#19. Pat Corp. began operations on January 1, 1984. A substantial part of Pat’s sales are made on the installment basis. For financial reporting, Pat recognizes revenues from all sales under the accrual method. However, on its income tax returns, Pat reports installment sales under the installment method. Pat’s gross profit on installment sales under each method was as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Accrual method</th>
<th>Installment method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>$800,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>1985</td>
<td>1,300,000</td>
<td>700,000</td>
</tr>
</tbody>
</table>

For both years, assume that the income tax rate is 40%, and that there are no other timing differences. In its
December 31, 1985, balance sheet, how much should Pat report as a liability for deferred income taxes?

- a. $240,000
- b. $360,000
- c. $400,000
- d. $440,000

2M85#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

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

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

D. Capitalized Lease Liability

1M87#21. On December 31, 1986, Ott Company leased a new machine from Wolf with the following pertinent information:

- Lease term: 12 years
- Annual rental payable at beginning of each year: $100,000
- Useful life of machine: 15 years
- Implicit interest rate: 12%
- Present value of an annuity of 1 in advance for 12 periods at 12%: 6.94

The lease contains no renewal options and the machine reverts to Wolf at the termination of the lease. The cost of the machine on Wolf’s accounting records is $750,000. At the inception of the lease, Ott should record a lease liability of

- a. $0
- b. $100,000
- c. $694,000
- d. $750,000

1M87#22. Kew Company leased equipment for its entire nine-year useful life, agreeing to pay $100,000 at the start of the lease term on December 31, 1985, and $100,000 annually on December 31 of the next eight years. The present value on December 31, 1985, of the nine lease payments over the lease term, discounted at the lessor’s implicit rate known by Kew to be 10%, was $633,000. The December 31, 1985 present value of the lease payments discounted at Kew’s incremental borrowing rate of 12% was $597,000. Kew made a timely second lease payment. The total lease liability at December 31, 1986, was

- a. $0
- b. $456,640
- c. $486,300
- d. $700,000

1N86#18. On January 2, 1986, Rice Company entered into a ten-year noncancelable lease, as lessee, requiring annual payments of $100,000 payable at the beginning of each year. Rice’s incremental borrowing rate is 14%, while the lessor’s implicit interest rate, known to Rice, is 12%. Present value factors of an annuity of 1 in advance for ten periods are 6.33 at 12%, and 5.95 at 14%. The leased property has an estimated useful life of 12 years. Ownership of the property remains with the lessor at expiration of the lease. At the inception of the lease, Rice should record a lease liability of

- a. $0
- b. $495,000
- c. $595,000
- d. $633,000

1N86#19. On December 31, 1984, Wall Company leased a machine from Ryan for a ten-year period expiring December 30, 1994. 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, 1984, and the second payment was made on December 31, 1985. The present value at December 31, 1984, of the ten lease payments over the lease term discounted at 10% was $676,000. The lease is appropriately accounted for as a capital lease by Wall. In its December 31, 1985, balance sheet Wall should report a lease liability of
   a. $486,000
   b. $518,400
   c. $533,600
   d. $500,000

1M86#21. Day, Inc., leased a machine for a period of eight years, contracting to pay $100,000 at inception of the lease term on December 31, 1984, and $100,000 annually on December 31 of the next seven years. The present value of the eight rent payments over the lease term, appropriately discounted at 10%, was $587,000. In its December 31, 1985, balance sheet, Day should report a liability under capital lease of
   a. $600,000
   b. $545,700
   c. $438,300
   d. $435,700

2M86#18. On March 1, 1986, Rory Corp. became the lessee of new equipment under a noncancelable six-year lease. The total estimated economic life of this equipment is ten years. The fair value of this equipment on March 1, 1986, was $100,000. The related investment tax credit retained by the lessor, is $10,000. The lease does not meet the criteria for classification as a capital lease with respect to transfer of ownership of the leased asset, or bargain purchase option, or lease term. Nevertheless, Rory must classify this lease as a capital lease if, at inception of the lease, the present value of the minimum lease payments (excluding executory costs) is equal to at least
   a. $67,500
   b. $81,000
   c. $90,000
   d. $99,000

1N85#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. $450,000
   c. $529,000
   d. $556,000

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

E. Bonds Payable

1M87#25. Glen Corporation had the following long-term debt:

<table>
<thead>
<tr>
<th>Bond Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sinking fund bonds, maturing in installments</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Industrial revenue bonds, maturing in installments</td>
<td>900,000</td>
</tr>
<tr>
<td>Subordinated bonds, maturing on a single date</td>
<td>1,500,000</td>
</tr>
</tbody>
</table>

The total of the serial bonds amounted to
   a. $1,500,000
   b. $2,000,000
   c. $2,400,000
   d. $3,500,000

1M87#26. On October 1, 1986, Dix, Inc., issued at 101 plus accrued interest, 400 of its 10%, $1,000 bonds. The bonds are dated July 1, 1986, and mature on July
1, 1996. Interest is payable semiannually on January 1 and July 1. At the time of issuance, Dix would receive cash of
   a. $394,000
   b. $404,000
   c. $410,000
   d. $414,000

1M87#27. On July 1, 1986, Lundy Company issued for $438,000, five hundred of its 8%, $1,000 bonds. The bonds were issued to yield 10%. The bonds are dated July 1, 1986, and mature on July 1, 1996. Interest is payable semiannually on January 1 and July 1. Using the interest method, how much of the bond discount should be amortized for the six months ended December 31, 1986?
   a. $3,800
   b. $3,100
   c. $2,480
   d. $1,900

1M87#28. On June 30, 1986, Frey Corp. had outstanding 8%, $2,000,000 face amount convertible bonds maturing on June 30, 1991. Interest is payable on June 30 and December 31. Each $1,000 bond is convertible into 40 shares of Frey's $20 par common stock. After amortization through June 30, 1986, the unamortized balance in the premium on bonds payable account was $50,000. On June 30, 1986, 1,000 bonds were converted when Frey's common stock had a market price of $30 per share. Using the book value method, what amount should Frey credit to additional paid-in capital in recording the conversion?
   a. $200,000
   b. $225,000
   c. $250,000
   d. $400,000

1M87#37. On April 1, 1987, Lane Corporation issued $1,500,000 of 10% nonconvertible bonds at 104 which are due on March 31, 1999. Each $1,000 bond was issued with 40 detachable stock warrants, each of which entitled the bondholder to purchase, for $50, one share of Lane common stock, $25 par. On April 1, 1987, the market value of Lane's common stock was $40 per share and the market value of each warrant was $4. What amount of the proceeds from the bond issue should Lane record as an increase in stockholders' equity?
   a. $1,500,000
   b. $240,000
   c. $60,000
   d. $0

1M87#38. On February 1, 1984, Dax Corp. issued 12%, $2,000,000 face amount, 10-year bonds for $2,234,000 plus accrued interest. The bonds are dated November 1, 1983, and interest is payable on May 1 and November 1. Dax reacquired all of these bonds at 102 on May 1, 1987, and retired them. Unamortized bond premium on that date was $156,000. Ignoring the income tax effect, what was Dax's gain on the bond retirement?
   a. $116,000
   b. $194,000
   c. $234,000
   d. $236,000

1N86#15. On January 1, 1985, Ward Corp. issued its 9% bonds in the face amount of $2,000,000, which mature on January 1, 1995. The bonds were issued for $1,878,000 to yield 10%, resulting in bond discount of $122,000. Ward uses the interest method of amortizing bond discount. Interest is payable annually on December 31. At December 31, 1985, Ward's unamortized bond discount should be
   a. $114,200
   b. $104,000
   c. $103,220
   d. $102,000

1N86#20. On July 1, 1986, Carr, Inc., issued at 104, one thousand of its 10%, $1,000 bonds. The bonds were issued through an underwriter to whom Carr paid bond issue costs of $25,000. On July 1, 1986, Carr should report the bond liability at
   a. $975,000
   b. $1,015,000
   c. $1,040,000
   d. $1,065,000

1N86#21. On January 1, 1979, Case, Inc., issued for $970,000, one thousand of its 9%, $1,000 convertible bonds. The bonds mature on December 31, 1993, and interest is payable on January 1 and July 1. The bonds can be called by Case at 101 on any interest payment date after December 31, 1984. The unamortized bond discount was $16,000 at December 31, 1985, and the market price of the bonds was 98 on this date. In its December 31, 1985, balance sheet, Case should report the carrying amount of the bonds at
   a. $980,000
   b. $984,000
   c. $986,000
   d. $1,010,000

1N86#22. On June 30, 1986, Frey Company had outstanding 8%, $1,000,000 face amount, 15-year bonds maturing on June 30, 1993. Interest is payable on June 30 and December 31. The unamortized balances on June 30, 1986, in the bond discount and deferred bond issue costs accounts were $35,000 and $10,000, respectively. Frey acquired all of these bonds at 94 on June 30, 1986, and retired them. Ignoring income taxes, how much gain should Frey report on this early extinguishment of debt?
   a. $15,000
   b. $25,000
   c. $35,000
   d. $60,000

AP-33
January The plus bonds standing in addition to report purchase face January 1, 1986, and mature on January 1 and July 1. From the bond issuance Bell would receive net cash of

- $199,000
- $196,500
- $194,000
- $189,000

On December 31, 1985, Cey, Inc., had outstanding 10%, $1,000,000 face amount convertible bonds maturing on December 31, 1990. Interest is payable on June 30 and December 31. Each $1,000 bond is convertible into 50 shares of Cey's $10 par common stock. On December 31, 1985, the unamortized balance in the premium on bonds payable account was $60,000. On December 31, 1985, 400 bonds were converted when Cey's common stock had a market price of $24 per share. Using the book value method, Cey's entry to record the conversion should include a credit to additional paid-in capital of

- $176,000
- $224,000
- $260,000
- $280,000

Wolf Company issued 1,000 of its $1,000 face amount, 20-year bonds on June 30, 1985, for $1,020,000. Each bond carries five detachable stock purchase warrants, each of which entitles the holder to purchase for $60 one share of Wolf's common stock. On June 30, 1985, the market prices were $50 per share of Wolf's common stock and $5 per warrant. In its June 30, 1985, balance sheet, at what amount should Wolf report the carrying amount of the bonds?

- $995,000
- $1,000,000
- $1,020,000
- $1,045,000

Zola Corp. had the following long-term debt:

- Bonds maturing in installments, secured by machinery $500,000
- Bonds maturing on a single date, secured by realty 900,000
- Collateral trust bonds 1,000,000

The debenture bonds amounted to

- $0
- $500,000
- $900,000
- $1,000,000

On January 1, 1985, when the market rate for bond interest was 12%, Ajax Corp. issued $1,000,000 face amount of bonds, with interest to be paid semiannually at a 10% annual rate. The bonds mature on December 31, 1994, and were issued at a discount of $114,500. How much of the discount should be amortized by the interest method at July 1, 1985?

- $1,145
- $3,130
- $5,725
- $6,870

On January 1, 1985, Okon Corp. issued 1,000 of its 9%, $1,000 bonds, at 95. Interest is payable semiannually on July 1 and January 1. The bonds mature on January 1, 1995. Okon paid bond issue costs of $40,000, which are appropriately recorded as a deferred charge. Okon uses the straight-line method of amortizing bond discount and bond issue costs. On Okon's December 31, 1985, balance sheet, how much would be shown as the carrying amount of the bonds payable?

- $919,000
- $955,000
- $991,000
- $1,045,000

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</th>
<th>Present Value Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>.386</td>
</tr>
<tr>
<td>5%</td>
<td>.377</td>
</tr>
</tbody>
</table>

The total issue price of the bonds is

- $875,480
- $877,600
- $980,000
- $1,000,000

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

- $24,000
- $22,300
- $21,240
- $20,000
Selected Questions

1N85#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

1M84#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#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

<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>$40,000</td>
<td>$50,900</td>
</tr>
<tr>
<td>12/31/84</td>
<td>40,000</td>
<td>43,610</td>
</tr>
<tr>
<td>12/31/85</td>
<td>40,000</td>
<td>37,250</td>
</tr>
<tr>
<td>12/31/86</td>
<td>40,000</td>
<td>31,690</td>
</tr>
<tr>
<td>12/31/87</td>
<td>40,000</td>
<td>26,830</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

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

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

2N84#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:

Arnold amortizes the bond discount by the interest method. In its December 31, 1983, balance sheet, at
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

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

F. Contingent Liabilities and Commitments

1M87#20. On January 17, 1987, an explosion occurred at a Cord Company plant causing extensive property damage to area buildings. Although no claims had yet been asserted against Cord by March 10, 1987, Cord's management and counsel concluded that it is reasonably possible Cord will be responsible for damages, and that $2,500,000 would be a reasonable estimate of its liability. Cord's $10,000,000 comprehensive public liability policy has a $500,000 deductible clause. In Cord's December 31, 1986 financial statements, which were issued on March 25, 1987, how should this item be reported?

a. No footnote disclosure or accrual is necessary.

b. As a footnote disclosure indicating the possible loss of $500,000.
c. As an accrued liability of $500,000.
d. As a footnote disclosure indicating the possible loss of $2,500,000.

1M87#30. During 1986 Beal Company became involved in a tax dispute with the IRS. At December 31, 1986, Beal's tax advisor believed that an unfavorable outcome was probable and a reasonable estimate of additional taxes was $500,000, but could be as much as $650,000. After the 1986 financial statements were issued, Beal received and accepted an IRS settlement offer of $550,000. What amount of accrued liability would Beal have reported in its December 31, 1986 balance sheet?

a. $650,000
b. $550,000
c. $500,000
d. $0

1N86#23. Mill Company sells washing machines that carry a three-year warranty against manufacturer's defects. Based on company experience, warranty costs are estimated at $30 per machine. During 1985 Mill sold 24,000 washing machines and paid warranty costs of $170,000. In its income statement for the year ended December 31, 1985, Mill should report warranty expense of

a. $170,000
b. $240,000
c. $550,000
d. $720,000

1N86#24. During 1985 Day Company sold 500,000 boxes of cake mix under a new sales promotional program. Each box contains one coupon, which submitted with $4.00, entitles the customer to a baking pan. Day pays $5.00 per pan and $.50 for handling and shipping. Day estimates that 80% of the coupons will be redeemed, even though only 300,000 coupons had been processed during 1985. What amount should Day report as a liability for unredeemed coupons at December 31, 1985?

a. $100,000
b. $150,000
c. $300,000
d. $500,000

1M86#20. Dunn Trading Stamp Company records stamp service revenue and provides for the cost of redemptions in the year stamps are sold to licensees. Dunn's past experience indicates that only 80% of the stamps sold to licensees will be redeemed. Dunn's liability for stamp redemptions was $12,000,000 at December 31, 1984. Additional information for 1985 is as follows:

Stamp service revenue from stamps sold to licensees $8,000,000
Cost of redemptions (stamps sold prior to 1/1/85) 5,500,000
Selected Questions

If all the stamps sold in 1985 were presented for redemption in 1986, the redemption cost would be $4,500,000. What amount should Dunn report as a liability for stamp redemptions at December 31, 1985?

a. $6,500,000
b. $10,100,000
c. $11,000,000
d. $14,500,000

2M86#7. The following information pertains to a fire insurance policy in effect during the calendar year 1985, covering Vail Co.'s inventory:

| Face amount of policy | $800,000 |
| Deductible clause     | 50,000 |
| Amount of premium      | 4,000 |
| Coinsurance clause    | 80% |

Vail's inventory averages $1,000,000 uniformly throughout the year. Vail's income tax rate is 40%. How much of a contingent liability should Vail accrue at December 31, 1985, to cover possible future fire losses?

a. $0
b. $30,000
c. $46,000
d. $120,000

1N85#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>Sales</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>$300,000</td>
</tr>
<tr>
<td></td>
<td>$4,500</td>
</tr>
<tr>
<td>1984</td>
<td>$500,000</td>
</tr>
<tr>
<td></td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>$800,000</td>
</tr>
<tr>
<td></td>
<td>$19,500</td>
</tr>
</tbody>
</table>

On December 31, 1984, Dall should report an estimated warranty liability of

a. $28,500
b. $22,500
c. $5,000
d. $0

2M85#3. On July 1, 1984, Dale Co. started a sales promotional campaign. In each box of cereal sold, Dale inserted a coupon redeemable for a premium. To receive a premium, each customer must submit five coupons. Dale's cost for each premium is $1. Dale estimated that 60% of the coupons issued will be redeemed. For the six months ended December 31, 1984, the following information is available:

Boxes of cereal sold       800,000
Coupons redeemed           200,000

The estimated liability for premium claims outstanding at December 31, 1984, should be

a. $40,000
b. $56,000
c. $72,000
d. $96,000

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

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

1N84#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?

a. $0
b. $400,000
c. $450,000
d. $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:

Stamp service revenue from stamps furnished to licensees $10,000,000
Cost of redemptions $8,500,000
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?

a. $9,500,000
b. $14,900,000
c. $18,500,000
d. $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?
   a. $0
   b. $500,000
   c. $600,000
   d. $900,000

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

A. Preferred and Common Stock

1N86/#25. On July 1, 1986, Hart Corporation issued 1,000 shares of its $10 par common and 2,000 shares of its $10 par convertible preferred stock for a lump sum of $40,000. At this date Hart's common stock was selling for $18 per share and the convertible preferred stock for $13.50 per share. The amount of proceeds allocated to Hart's preferred stock should be
   a. $22,000
   b. $24,000
   c. $27,000
   d. $30,000

1N86/#26. The stockholders' equity section of Kern Corporation's balance sheet at December 31, 1985, was as follows:

| Common stock, $10 par; authorized 1,000,000 shares; issued and outstanding 900,000 shares | $ 9,000,000 |
| Additional paid-in capital | 2,700,000 |
| Retained earnings | 1,300,000 |
| Total stockholders' equity | $13,000,000 |

All outstanding shares of common stock were issued in 1983 for $13 per share. On January 2, 1986, Kern acquired 100,000 shares of its stock at $12 per share and retired them. Immediately after retirement of the shares, the balance in additional paid-in capital should be
   a. $2,800,000
   b. $2,600,000
   c. $2,500,000
   d. $2,400,000

1N86/#28. Dix Corporation's stockholders' equity at December 31, 1985, consisted of the following:

| 8% cumulative preferred stock, $50 par; liquidating value $55 per share; authorized, issued and outstanding 20,000 shares | $1,000,000 |
| Common stock, $25 par; 200,000 shares authorized; 100,000 shares issued and outstanding | 2,500,000 |
| Retained earnings | 400,000 |

Dividends on preferred stock have been paid through 1984 but have not been declared for 1985. At December 31, 1985, Dix's book value (equity) per common share was
   a. $25.00
   b. $27.20
   c. $28.20
   d. $29.00

2N85
Items 12 through 16 are based on the following data:

Beef Corporation

STOCKHOLDERS' EQUITY
December 31, 1983

| Common stock, $1 par value; authorized 3,000,000 shares; issued 1,500,000 shares; outstanding 1,400,000 shares | $ 1,400,000 |
| Additional paid-in capital: | |
| In excess of par | 14,000,000 |
| From treasury stock | 200,000 |
| Total paid-in capital | 15,600,000 |
| Unappropriated retained earnings | 8,100,000 |
| Total stockholders' equity | $23,700,000 |

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.
Selected Questions

- 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

1M85
Items 14 and 15 are based on the following data:

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 $100,000

Common stock, par value $25; authorized 100,000 shares; issued and outstanding 10,000 shares $250,000

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

14. How much was Frey’s book value per preferred share at December 31, 1984?
   a. $100
   b. $105
   c. $110
   d. $115

15. How much was Frey’s book value per common share at December 31, 1984?
   a. $45.00
   b. $68.50
   c. $69.50
   d. $70.00

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?
   a. $320,000
   b. $351,000
   c. $354,000
   d. $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 $500,000
  Common stock, $10 par value; 80,000 shares issued and outstanding 800,000
  Retained earnings 300,000

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

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

  Common stock ($10 par value, authorized 1,000,000 shares, issued and outstanding 900,000 shares) $9,000,000
  Additional paid-in capital 2,700,000
  Retained earnings 1,300,000
  Total stockholders’ equity $13,000,000
Accounting Practice

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:

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

B. Additional Paid-in Capital

1N86#27. On October 1, 1986, Ames Company issued 2,000 shares of its $10 par common stock to Clark for a tract of land. The stock had a fair market value of $18 per share on this date. On Clark’s last property tax bill the land was assessed at $24,000. Ames should record an increase in additional paid-in capital of:

a. $0
b. $ 4,000
c. $10,000
d. $16,000

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

C. Retained Earnings and Dividends

1M87#34. During 1987, Paul Company discovered that the ending inventories reported on its financial statements were incorrect by the following amounts:

1985  $60,000 understated
1986  75,000 overstated

Paul uses the periodic inventory system to ascertain year-end quantities that are converted to dollar amounts using the FIFO cost method. Prior to any adjustments for these errors and ignoring income taxes, Paul’s retained earnings at January 1, 1987, would be:

a. Correct.
b. $ 15,000 overstated.
c. $ 75,000 overstated.
d. $135,000 overstated.

1N86#31. On July 1, 1986, Bart Corporation has 200,000 shares of $10 par common stock outstanding and the market price of the stock is $12 per share. On the same date, Bart declared a 1-for-2 reverse stock split. The par of the stock was increased from $10 to $20 and one new $20 par share was issued for each two $10 par shares outstanding. Immediately before the 1-for-2 reverse stock split, Bart’s additional paid-in capital was $450,000. What should be the balance in Bart’s additional paid-in capital account immediately after the reverse stock split is effected?

a. $0
b. $450,000
c. $650,000
d. $850,000

1N86#39. Huff, Inc., had marketable securities with a carrying amount of $300,000 on December 20, 1985. On the same date a property dividend of these securities was declared. Pertinent information as to the fair value of the securities was as follows:

<table>
<thead>
<tr>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Declaration date — 12/20/85 $390,000</td>
</tr>
<tr>
<td>Record date — 1/13/86 405,000</td>
</tr>
<tr>
<td>Distribution date — 1/27/86 400,000</td>
</tr>
</tbody>
</table>

For the year ended December 31, 1985, how much gain on disposal of marketable securities should Huff recognize as a result of this property dividend?

a. $0
b. $ 90,000
c. $100,000
d. $105,000

2N85

Items 12 through 16 are based on the following data:

**Beef Corporation**

**STOCKHOLDERS’ EQUITY**

**December 31, 1983**

Common stock, $1 par value; authorized 3,000,000 shares; issued 1,500,000 shares; outstanding 1,400,000 shares $1,400,000

Additional paid-in capital:

- In excess of par 14,000,000
- From treasury stock 200,000

Total paid-in capital 15,600,000

Unappropriated retained earnings 8,100,000

Total stockholders’ equity 23,700,000

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.

AP-40
Selected Questions

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 $15.00 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>

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

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</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>30,000 shares; issued and outstanding</td>
<td>90,000</td>
</tr>
<tr>
<td>9,000 shares</td>
<td>116,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>146,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>$352,000</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

1M84#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
Accounting Practice

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 overstatement in the cost of goods sold for the year ended December 31, 1982. In October 1983, Terry paid $500,000 in settlement of litigation instituted against it during 1982. Ignore income taxes. In the 1983 financial statements the December 31, 1982, retained earnings balance, as previously reported, should be adjusted by a

1. $150,000 credit.
2. $350,000 debit.
3. $500,000 debit.
4. $650,000 credit.

2N83#6. The following information pertains to a property dividend of marketable securities, declared by Tyson Corp.:

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Declaration date</td>
<td>December 20, 1982</td>
</tr>
<tr>
<td>Record date</td>
<td>January 10, 1983</td>
</tr>
<tr>
<td>Distribution date</td>
<td>January 28, 1983</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

2M83#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>

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.

D. Treasury Stock and Other Contra Accounts

1N86#32. Cox Corporation was organized on January 1, 1983, at which date it issued 100,000 shares of $10 par common stock at $15 per share. During the period January 1, 1983, through December 31, 1985, Cox reported net income of $450,000 and paid cash dividends of $230,000. On January 10, 1985, Cox purchased 6,000 shares of its common stock at $12 per share. On December 31, 1985, Cox sold 4,000 treasury shares at $8 per share. Cox uses the cost method of accounting for treasury shares. What is Cox’s total stockholders’ equity at December 31, 1985?

a. $1,720,000
b. $1,704,000
c. $1,688,000
d. $1,680,000

2N85

Items 12 through 16 are based on the following data:

Beef Corporation

STOCKHOLDERS’ EQUITY

December 31, 1983

Common stock, $1 par value;
authorized 3,000,000 shares;
issued 1,500,000 shares;
outstanding 1,400,000 shares $1,400,000

Additional paid-in capital:
In excess of par 14,000,000
From treasury stock 200,000

Total paid-in capital 15,600,000

Unappropriated retained earnings 8,100,000

Total stockholders’ equity $23,700,000

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.
Selected Questions

- 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>
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<th>Suit</th>
<th>Likelihood of losing the suit</th>
<th>Estimated loss</th>
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<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>

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

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

E. Stock Options, Warrants, and Rights

1N86#33. On January 1, 1984, Burr, Inc., granted its president an option to purchase 2,000 shares of Burr's stock at $40 per share. The option became exercisable on December 31, 1985, after the president completed two years of service. The option was exercised early in 1986. The market prices of Burr's stock were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 1984</td>
<td>$60</td>
</tr>
<tr>
<td>December 31, 1985</td>
<td>85</td>
</tr>
</tbody>
</table>

For 1985, Burr should recognize compensation expense of
   a. $0
   b. $20,000
   c. $40,000
   d. $45,000

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

F. Reorganization and Change in Entity

1N86#35. On January 1, 1985, Pitt Company purchased an 80% investment in Saxe Company. The acquisition cost was equal to Pitt's equity in Saxe's net assets at that date. On January 1, 1985, Pitt and Saxe had retained earnings of $500,000 and $100,000, respectively. During 1985: (1) Pitt had net income of $200,000, which included its equity in Saxe's earnings, and declared dividends of $50,000, (2) Saxe had net income of $40,000 and declared dividends of $20,000, and (3) there were no other intercompany transactions between the parent and subsidiary. On December 31, 1985, the consolidated retained earnings should be
   a. $650,000
   b. $666,000
   c. $766,000
   d. $770,000

2N85#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

2N85
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. Im-
Accounting Practice

Immediatedly 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

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></th>
<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>
<td>$600,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>25,000</td>
<td>35,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>120,000</td>
<td>210,000</td>
<td>330,000</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></th>
<th>Book carrying amount</th>
<th>Estimated current value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets pledged with fully secured creditors</td>
<td>$150,000</td>
<td>$185,000</td>
</tr>
<tr>
<td>Assets pledged with partially secured creditors</td>
<td>90,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Free assets</td>
<td>210,000</td>
<td>160,000</td>
</tr>
<tr>
<td></td>
<td>$450,000</td>
<td>$405,000</td>
</tr>
<tr>
<td>Liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities with priority</td>
<td>$35,000</td>
<td></td>
</tr>
<tr>
<td>Fully secured creditors</td>
<td>130,000</td>
<td></td>
</tr>
<tr>
<td>Partially secured creditors</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Unsecured creditors</td>
<td>270,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$555,000</td>
<td></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

Assume that the assets are converted into cash at the estimated current values and the business is liquidated. How much cash will be available to pay unsecured non-priority claims?
   a. $240,000  
   b. $180,000  
   c. $160,000  
   d. $125,000

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Selected Questions

1N83#8. Scott Company filed a voluntary bankruptcy petition on June 25, 1982, and the statement of affairs reflects the following amounts:

<table>
<thead>
<tr>
<th></th>
<th>Book carrying amount</th>
<th>Estimated current value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets pledged with fully secured creditors</td>
<td>$160,000</td>
<td>$190,000</td>
</tr>
<tr>
<td>Assets pledged with partially secured creditors</td>
<td>$90,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Free assets</td>
<td>$200,000</td>
<td>$140,000</td>
</tr>
<tr>
<td></td>
<td>$450,000</td>
<td>$390,000</td>
</tr>
<tr>
<td>Liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities with priority</td>
<td>$20,000</td>
<td></td>
</tr>
<tr>
<td>Fully secured creditors</td>
<td>$130,000</td>
<td></td>
</tr>
<tr>
<td>Partially secured creditors</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Unsecured creditors</td>
<td>$260,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$510,000</td>
<td></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

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

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

G. Partnerships

1N87#33. On January 1, 1987, the partners of Cobb, Davis, and Eddy, who share profits and losses in the ratio of 5:3:2, respectively, decided to liquidate their partnership. On this date the partnership condensed balance sheet was as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$50,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>$250,000</td>
</tr>
<tr>
<td>Liabilities and Capital</td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td>$60,000</td>
</tr>
<tr>
<td>Cobb, capital</td>
<td>$80,000</td>
</tr>
<tr>
<td>Davis, capital</td>
<td>$90,000</td>
</tr>
<tr>
<td>Eddy, capital</td>
<td>$70,000</td>
</tr>
<tr>
<td>Total</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

On January 15, 1987, the first cash sale of other assets with a carrying amount of $150,000 realized $120,000. Safe installment payments to the partners were made the same date. How much cash should be distributed to each partner?

<table>
<thead>
<tr>
<th>Cobb</th>
<th>Davis</th>
<th>Eddy</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $15,000</td>
<td>$51,000</td>
<td>$44,000</td>
</tr>
<tr>
<td>b. $40,000</td>
<td>$45,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>c. $55,000</td>
<td>$33,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>d. $60,000</td>
<td>$36,000</td>
<td>$24,000</td>
</tr>
</tbody>
</table>

1N87#40. Fox, Greg, and Howe are partners with average capital balances during 1986 of $120,000, $60,000, and $40,000, respectively. Partners receive 10% interest on their average capital balances. After deducting salaries of $30,000 to Fox and $20,000 to Howe, the residual profit or loss is divided equally. In 1986 the partnership sustained a $33,000 loss before interest and salaries to partners. By what amount should Fox's capital account change?

a. $7,000 increase.
b. $11,000 decrease.
c. $35,000 decrease.
d. $42,000 increase.

1N86#36. At December 31, 1985, Reed and Quinn are partners with capital balances of $40,000 and $20,000, and they share profit and loss in the ratio of...
2:1, respectively. On this date Poe invests $17,000 cash for a one-fifth interest in the capital and profit of the new partnership. Assuming that goodwill is not recorded, how much should be credited to Poe’s capital account on December 31, 1985?

a. $12,000  
b. $15,000  
c. $15,400  
d. $17,000

2N85  
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>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$90,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>830,000</td>
</tr>
<tr>
<td>Lever, loan</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$940,000</strong></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><strong>Total</strong></td>
<td><strong>$940,000</strong></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

1M85#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 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:

- Jones: $100,000  
- King: 200,000  
- Lane: 300,000

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>Account</th>
<th>Ames</th>
<th>Buell</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$70,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Land</td>
<td>$310,000</td>
<td></td>
</tr>
</tbody>
</table>

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Selected Questions

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>Ames</th>
<th>Buell</th>
<th>Carter</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $60,000</td>
<td>$60,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>b. $63,333</td>
<td>$56,667</td>
<td>$60,000</td>
</tr>
<tr>
<td>c. $64,000</td>
<td>$56,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>d. $70,000</td>
<td>$60,000</td>
<td>$50,000</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>Mira</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$65,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Realty</td>
<td>300,000</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

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

1M87#35. Tone Company is the defendant in a lawsuit filed by Witt in 1985 disputing the validity of a copyright held by Tone. At December 31, 1985, Tone determined that Witt would probably be successful against Tone for an estimated amount of $400,000. Appropriately, a $400,000 loss was accrued by a charge to income for the year ended December 31, 1985. On December 15, 1986, Tone and Witt agreed to a settlement providing for cash payment of $250,000 by Tone to Witt, and transfer of Tone’s copyright to Witt. The carrying amount of the copyright on Tone’s accounting records was $60,000 at December 15, 1986. What would be the effect of the settlement on Tone’s income before income tax in 1986?

a. No effect.
b. $ 60,000 decrease.
c. $ 90,000 increase.
d. $150,000 increase.

1M87#36. Certain balance sheet accounts of a foreign subsidiary of Post, Inc., at December 31, 1986, have been translated into U.S. dollars as follows:

<table>
<thead>
<tr>
<th>Translated at</th>
<th>Current rates</th>
<th>Historical rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable, long-term</td>
<td>$120,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>55,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Copyright</td>
<td>75,000</td>
<td>85,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$250,000</strong></td>
<td><strong>$235,000</strong></td>
</tr>
</tbody>
</table>

The subsidiary’s functional currency is the currency of the country in which it is located. What total amount should be included in Post’s December 31, 1986 consolidated balance sheet for the above accounts?

a. $225,000
b. $235,000
c. $240,000
d. $250,000

1M87#39. On January 2, 1985, Winn Company purchased as a long-term investment 5,000 shares of Pyle Corp. common stock for $70 per share, which represents a 1% interest. On December 31, 1985, the market price of the stock was $75 per share. On December 18, 1986, Winn needed additional cash for operations and sold all 5,000 shares of Pyle stock for $100 per share. Winn’s income tax rate was 40% for 1986. For the year ended December 31, 1986, Winn should include in its income from continuing operations a gain on disposal of long-term investment of

a. $0
b. $ 75,000
c. $125,000
d. $150,000

2M87 Items 1 and 2 are based on the following data relating to a construction job started by Syl Co. during 1986:

- Total contract price: $100,000
- Actual costs during 1986: 20,000
- Estimated remaining costs: 40,000
- Billed to customer during 1986: 30,000
- Received from customer during 1986: 10,000

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1. Under the completed contract method, how much should Syl recognize as gross profit for 1986?
   a. $0
   b. $4,000
   c. $10,000
   d. $12,000

2. Under the percentage-of-completion method, how much should Syl recognize as gross profit for 1986?
   a. $0
   b. $13,333
   c. $26,667
   d. $33,333

2M67#3. On January 1, 1986, Neu Co. sold equipment costing $300,000, with accumulated depreciation of $160,000 on the date of sale. Neu received as consideration for the sale a $400,000 noninterest bearing note due January 1, 1989. There was no established exchange price for the equipment, and the note had no ready market. The prevailing rate of interest for a note of this type at January 1, 1986, was 10%. The present value of 1 at 10% for three periods is 0.75. In Neu's 1986 income statement, how much should be included for interest income?
   a. $40,000
   b. $33,333
   c. $30,000
   d. $13,500

2M67#13. On May 1, 1986, Lane Corp. bought a parcel of land for $100,000. Seven months later, Lane sold this land to a triple-A rated company for $150,000, under the following terms: 25% at closing, and a first mortgage note (at the market rate of interest) for the balance. The first payment on the note, plus accrued interest, is due December 1, 1987. Lane reported this sale on the installment basis in its 1986 tax return. In its 1986 income statement, how much gain should Lane report from the sale of this land?
   a. $0
   b. $12,500
   c. $37,500
   d. $50,000

2M67#14. James Lee, M.D., keeps his accounting records on a cash basis. During 1986, Dr. Lee collected $100,000 in fees from his patients. At December 31, 1985, Dr. Lee had accounts receivable of $20,000. At December 31, 1986, Dr. Lee had accounts receivable of $30,000, and unearned fees of $1,000. On an accrual basis, how much was Dr. Lee's patient service revenue for 1986?
   a. $111,000
   b. $109,000
   c. $90,000
   d. $89,000

2M67 Items 15 through 17 are based on the following data:

Lake Corporation's accounting records showed the following investments at January 1, 1986:

Common stock:
   Kar Corp. (1,000 shares) $10,000
   Aub Corp. (5,000 shares) 100,000

Real estate:
   Parking lot (leased to Day Co.) 300,000

Other:
   Trademark (at cost, less accumulated amortization) 25,000

Total investments $435,000

Lake owns 1% of Kar and 30% of Aub. Lake's directors constitute a majority of Aub's directors. The Day lease, which commenced on January 1, 1984, is for ten years, at an annual rental of $48,000. In addition, on January 1, 1984, Day paid a nonrefundable deposit of $50,000, as well as a security deposit of $8,000 to be refunded upon expiration of the lease. The trademark was licensed to Barr Co. for royalties of 10% of sales of the trademarked items. Royalties are payable semiannually on March 1 (for sales in July through December of the prior year), and on September 1 (for sales in January through June of the same year).

During the year ended December 31, 1986, Lake received cash dividends of $1,000 from Kar, and $15,000 from Aub, whose 1986 net incomes were $75,000 and $150,000, respectively. Lake also received $48,000 rent from Day in 1986, and the following royalties from Barr:

<table>
<thead>
<tr>
<th>March 1</th>
<th>September 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$3,000</td>
</tr>
<tr>
<td>1986</td>
<td>4,000</td>
</tr>
</tbody>
</table>

Barr estimated that sales of the trademarked items would total $20,000 for the last half of 1986.

15. In Lake's 1986 income statement, how much should be reported for dividend revenue?
   a. $16,000
   b. $2,400
   c. $1,000
   d. $150

16. In Lake's 1986 income statement, how much should be reported for royalty revenue?
   a. $14,000
   b. $13,000
   c. $11,000
   d. $9,000
Selected Questions

17. In Lake's 1986 income statement, how much should be reported for rental revenue?
   a. $43,000
   b. $48,000
   c. $53,000
   d. $53,800

2M87#19. In November and December 1986, Gee Co., a newly organized magazine publisher, received $36,000 for 1,000 three-year subscriptions at $12 per year, starting with the January 1987 issue of the magazine. Gee elected to include the entire $36,000 in its 1986 income tax return. How much should Gee report in its 1986 income statement for subscriptions revenue?
   a. $36,000
   b. $12,000
   c. $2,000
   d. $0

2M87#20. Lin Co., a distributor of machinery, bought a machine from the manufacturer in November 1986 for $10,000. On December 30, 1986, Lin sold this machine to Zee Hardware for $15,000, under the following terms: 2% discount if paid within 30 days, 1% discount if paid after 30 days but within 60 days, or payable in full within 90 days if not paid within the discount periods. However, Zee had the right to return this machine to Lin if Zee was unable to resell the machine before expiration of the 90-day payment period, in which case Zee's obligation to Lin would be canceled. In Lin's net sales for the year ended December 31, 1986, how much should be included for the sale of this machine to Zee?
   a. $0
   b. $14,700
   c. $14,850
   d. $15,000

1N86#29. Grey Company manufactures equipment which is sold or leased. On December 31, 1985, Grey leased equipment to Ray for a five-year period expiring December 31, 1990, at which date ownership of the leased asset will be transferred to Ray. Equal payments under the lease are $40,000 and are due on December 31 of each year. The first payment was made on December 31, 1985. Collectibility of the remaining lease payments is reasonably assured and Grey has no material cost uncertainties. The normal sales price of the equipment is $154,000 and cost is $120,000. For the year ended December 31, 1985, how much income should Grey realize from the lease transaction?
   a. $46,000
   b. $40,000
   c. $34,000
   d. $0

1N86#30. Cord Builders, Inc., has consistently used the percentage-of-completion method of accounting for construction-type contracts. During 1984 Cord started work on a $9,000,000 fixed-price construction contract that was completed in 1986. Cord's accounting records disclosed the following:

<table>
<thead>
<tr>
<th>December 31</th>
<th>1984</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative contract costs incurred</td>
<td>$3,900,000</td>
<td>$6,300,000</td>
</tr>
<tr>
<td>Estimated total costs at completion</td>
<td>7,800,000</td>
<td>8,100,000</td>
</tr>
</tbody>
</table>

How much income would Cord have recognized on this contract for the year ended December 31, 1985?
   a. $100,000
   b. $300,000
   c. $600,000
   d. $700,000

1N86#34. Kew Company began operations on January 1, 1985, and appropriately uses the installment method of accounting. Data available for 1985 are as follows:

Installment accounts receivable, 12/31/85 | $500,000 |
Installment sales | 900,000 |
Cost of goods sold, as percentage of sales | 60%

Using the installment method, Kew's realized gross profit for 1985 would be
   a. $160,000
   b. $200,000
   c. $240,000
   d. $360,000

1N86#37. In its accrual basis income statement for the year ended December 31, 1985, Dart Company reported revenue of $1,750,000. Additional information was as follows:

Accounts receivable — 12/31/84 | $ 375,000 |
Uncollectible accounts written off during 1985 | 20,000 |
Accounts receivable — 12/31/85 | 505,000 |

Under the cash basis, how much should Dart report as revenue for 1985?
   a. $1,620,000
   b. $1,600,000
   c. $1,395,000
   d. $1,375,000

1N86#38. On January 2, 1985, Kemp Company assigned its patent to Wilson for royalties of 10% of patent related sales. The same date Kemp received a $25,000 royalty advance to be applied against royalties for 1985 sales. On July 31, 1985, Wilson reported sales of $200,000 for the six-month period ended June 30, 1985. In January 1986, before issuance of its 1985 financial statements, Kemp learned that Wilson's sales totaled

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$275,000 for the last half of 1985. How much royalty income should Kemp report in its 1985 income statement?

- $25,000
- $45,000
- $47,500
- $52,500

**1M86#40.** On July 1, 1985, Fay Company purchased $1,000,000 of West Company's 8% bonds due on July 1, 1995. Fay expects to hold the bonds until maturity. The bonds, which pay interest semiannually on January 1 and July 1, were purchased for $875,000 to yield 10%. In its income statement for the year ended December 31, 1985, Fay should report interest income at

- $35,000
- $40,000
- $43,750
- $50,000

**1M86#42.** On January 1, 1985, Taft Company leased a warehouse to Green under an operating lease for ten years at $40,000 per year, payable the first day of each lease year. Taft paid $18,000 to a real estate broker as a finder's fee. The warehouse is depreciated $10,000 per year. During 1985 Taft incurred insurance and property tax expense totaling $7,500. Taft's net rental income for 1985 should be

- $20,700
- $22,000
- $22,500
- $30,000

**1M86#43.** Post, Inc., had a credit translation adjustment of $30,000 for the year ended December 31, 1985. The functional currency of Post's subsidiary is the currency of the country in which it is located. Additionally, Post had a receivable from a foreign customer payable in the local currency of the customer. On December 31, 1984, this receivable for 200,000 local currency units (LCU) was correctly included in Post's balance sheet at $110,000. When the receivable was collected on February 15, 1985, the United States dollar equivalent was $120,000. In Post's 1985 consolidated income statement, how much should be reported as foreign exchange gain?

- $0
- $10,000
- $30,000
- $40,000

**1M86#27.** During 1985 Kew Company, a service organization, had $200,000 in cash sales and $3,000,000 in credit sales. The accounts receivable balances were $400,000 and $485,000 at December 31, 1984 and 1985, respectively. If Kew desires to prepare a cash basis income statement, how much should be reported as sales for 1985 on a cash basis?

- $3,285,000
- $3,200,000
- $3,115,000
- $2,915,000

**1M86#30.** Marr Construction Company has consistently used the percentage-of-completion method. On January 10, 1984, Marr began work on a $6,000,000 construction contract. At the inception date, the estimated cost of construction was $4,500,000. The following data relate to the progress of the contract:

<table>
<thead>
<tr>
<th>Income recognized at 12/31/84</th>
<th>$600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost incurred 1/10/84 through 12/31/85</td>
<td>3,600,000</td>
</tr>
<tr>
<td>Estimated cost to complete at 12/31/85</td>
<td>1,200,000</td>
</tr>
</tbody>
</table>

How much income should Marr recognize for the year ended December 31, 1985?

- $300,000
- $525,000
- $600,000
- $900,000

**1M86#32.** On November 30, 1985, North Company consigned 30 freezers to West Company for sale at $800 each and paid $600 in transportation costs. An account sales was received on December 30, 1985, from West reporting the sale of 10 freezers, together with a remittance of the $6,800 balance due. The remittance was net of the agreed 15% commission. How much, and in what month, should North recognize as consignment sales revenue?

<table>
<thead>
<tr>
<th>November 1985</th>
<th>December 1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$8,000</td>
</tr>
<tr>
<td>b. $0</td>
<td>$7,800</td>
</tr>
<tr>
<td>c. $23,400</td>
<td>$0</td>
</tr>
<tr>
<td>d. $24,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

**1M86#33.** On December 31, 1984, Gill Company sold a plant facility to Cox, Inc., for $2,100,000, when the plant had a carrying amount of $1,400,000. Cox paid $300,000 cash on December 31, 1984, and signed a $1,800,000 note bearing interest at 10%, payable in six annual installments of $300,000. Gill appropriately accounts for the sale under the installment method. On December 31, 1985, Cox paid $300,000 principal and $180,000 interest. For the year ended December 31, 1985, what total amount of income should Gill recognize from the plant sale and financing?

- $0
- $100,000
- $180,000
- $280,000

**1M86#34.** On January 1, 1985, Elia Company sold a building, which had a carrying amount of $350,000, receiving a $125,000 down payment and, as additional consideration, a $400,000 noninterest bearing note due on January 1, 1988. 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, 1985, was 10%. The present value...
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of 1 at 10% for three periods is 0.75. What amount of interest income should be included in Elia's 1985 income statement?

a. $0
b. $30,000
c. $35,000
d. $40,000

1M86#35. On January 1, 1985, Bart Company acquired as a long-term investment for $700,000, a 20% common stock interest in Hall Company when the fair value of Hall's net assets was $3,500,000. Bart can exercise significant influence over operating and financial policies of Hall. For the year ended December 31, 1985, Hall reported net income of $360,000, declared, and paid cash dividends of $100,000. How much investment income from this investment should Bart report for 1985?

a. $92,000
b. $72,000
c. $52,000
d. $20,000

1M86#36. On November 1, 1985, Yost Corporation issued shares of its voting common stock in exchange for all of the voting common stock of Zeno, 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>Yost</th>
<th>Zeno</th>
</tr>
</thead>
<tbody>
<tr>
<td>12 months ended 12/31/85</td>
<td>$1,500,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>2 months ended 12/31/85</td>
<td>165,000</td>
<td>150,000</td>
</tr>
</tbody>
</table>

During September Zeno paid $450,000 in dividends to its stockholders. For the year ended December 31, 1985, the consolidated net income should be

a. $ 315,000
b. $1,650,000
c. $1,950,000
d. $2,400,000

1M86#38. Rice Company owns 300 shares of Wood Corporation common stock acquired on July 24, 1984, at a total cost of $11,000. On December 2, 1985, Rice received 300 stock rights from Wood. Each right entitles the holder to acquire one share of stock for $45. The market price of Wood's stock on this date, ex-rights, was $50 and the market price of each right was $5. Rice sold its rights the same date for $5 a right less a $90 commission. The gain from the sale of the rights should be reported by Rice at

a. $1,500
b. $1,410
c. $ 500
d. $ 410

1M86#39. Huff Company acquired 2,000 shares of Post, Inc., common stock on October 5, 1983, at a cost of $44,000. On April 10, 1985, Post distributed a 10% common stock dividend when the market price of the stock was $30 per share. On December 20, 1985, Huff sold 200 shares of its Post stock for $6,400. For the year ended December 31, 1985, how much should Huff report as dividend income and gain on sale?

<table>
<thead>
<tr>
<th>Dividend income</th>
<th>Gain on sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$2,400</td>
</tr>
<tr>
<td>b. $0</td>
<td>$6,400</td>
</tr>
<tr>
<td>c. $6,000</td>
<td>$ 400</td>
</tr>
<tr>
<td>d. $6,000</td>
<td>$2,400</td>
</tr>
</tbody>
</table>

1M86#40. Kay Company, a lessor of office machines, purchased a new machine for $600,000 on January 1, 1985, which was leased the same day to Lee. The machine will be depreciated $55,000 per year. The lease is for a four-year period expiring January 1, 1989, and provides for annual rental payments of $100,000 beginning January 1, 1985. Additionally, Lee paid $64,000 to Kay as a lease bonus. In its 1985 income statement, what amount of revenue and expense should Kay report on this leased asset?

<table>
<thead>
<tr>
<th>Revenue</th>
<th>Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $100,000</td>
<td>$0</td>
</tr>
<tr>
<td>b. $116,000</td>
<td>$0</td>
</tr>
<tr>
<td>c. $116,000</td>
<td>$55,000</td>
</tr>
<tr>
<td>d. $164,000</td>
<td>$55,000</td>
</tr>
</tbody>
</table>

1M86#53. Town, a calendar-year corporation incorporated in January 1982, experienced a $600,000 net operating loss (NOL) in 1985. For the years 1982-1984, Town reported a taxable income in each year, and a total of $450,000 for the three years. Assume that: (1) there is no difference between pretax accounting income and taxable income for all years, (2) the income tax rate is 40% for all years, (3) the NOL will be carried back to the profit years 1982-1984 to the extent of $450,000, and $150,000 will be carried forward to future periods. Town believes that realization of the tax benefit of the loss carryforward is assured beyond any reasonable doubt. In its 1985 income statement, what amount should Town report as the reduction of loss due to NOL carryback and carryforward?

a. $180,000
b. $240,000
c. $270,000
d. $360,000

1N85#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.
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

1N85#28. Green Company, which began operations on January 1, 1984, appropriately uses the installment method of accounting. The following information is available for 1984:

Gross profit on sales
Deferred gross profit at 12/31/84
Cash collected, including down payments

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

1N85#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

1N85#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

1N85#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

1N85#33. During 1983 a textbook written by Burr Corporation 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

1N85#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

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1M85#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>

1M85#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

1M85#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

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:

- Costs incurred: $930,000
- Estimated cost to complete: 2,170,000
- Progress billings: 1,100,000
- Collections: 700,000

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>Translated at</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#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 1, 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. $20,000

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 1985 sales. On September 30, 1984, Western made a $21,000 royalties 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?
   a. $21,000
   b. $46,000
c. $71,000
d. $85,000

1M85#33. On January 1, 1984, Bishop Company, a lessor 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?
   a. $5,000
   b. $8,000
c. $55,000
d. $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.

1M85#50. 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 of 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 incurred</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?

a. $250,000  
b. $416,667  
c. $500,000  
d. $562,500

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?

a. $20,000  
b. $32,000  
c. $38,000  
d. $60,000

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?

a. $0  
b. $7,264  
c. $22,736  
d. $30,000

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?

a. $40,000  
b. $33,333  
c. $30,000  
d. $13,500

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

1N84#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

1N84#48. Walker, Inc., a U.S. corporation, ordered a machine from Pfau Company of West Germany on July 15, 1983, for 100,000 marks when the spot rate for marks was $.4955. Pfau 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>1,800,000</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#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#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 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#54. 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

1M83#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
Selected Questions

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?

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?

2M83

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

2M83

2N83#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?

2M83

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:

- Noncancelable 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>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joyce Corp. (2,000 shares)</td>
<td></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>80,000</td>
</tr>
<tr>
<td>(original preparation and printing costs)</td>
<td></td>
</tr>
<tr>
<td>Total investments</td>
<td>$1,580,000</td>
</tr>
</tbody>
</table>

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).
Accounting Practice

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

B. Expenses and Losses

1M87#31. The following information is available for Bart Company for 1986:

Disbursements for purchases $580,000
Increase in trade accounts payable 50,000
Decrease in merchandise inventory 20,000

Cost of goods sold for 1986 was
   a. $650,000
   b. $610,000
   c. $550,000
   d. $510,000

1M87#32. On July 1, 1986, Cody Company obtained a $2,000,000, 180-day bank loan at an annual rate of 12%. The loan agreement requires Cody to maintain a $400,000 compensating balance in its checking account at the lending bank. Cody would otherwise maintain a balance of only $200,000 in this account. The checking account earns interest at an annual rate of 6%. Based on a 360-day year, the effective interest rate on the borrowing is
   a. 12.00%
   b. 12.67%
   c. 13.33%
   d. 13.50%

1M87#41. During 1986, Mason Company incurred the following costs:

Research and development services performed by Lee Corp. for Mason $300,000
Testing for evaluation of new products 250,000
Laboratory research aimed at discovery of new knowledge 370,000

In its income statement for the year ended December 31, 1986, Mason should report research and development expense of
   a. $920,000
   b. $670,000
   c. $300,000
   d. $250,000

1M87#42. Barr Company's unadjusted trial balance at December 31, 1986, included the following accounts:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for doubtful accounts</td>
<td>$3,200</td>
</tr>
<tr>
<td>Sales</td>
<td>$1,445,000</td>
</tr>
<tr>
<td>Sales returns</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Barr estimates its uncollectible receivables at 2% of net sales. For 1986, Barr should report doubtful accounts expense of
   a. $31,600
   b. $28,900
   c. $28,400
   d. $25,200

1M87#43. On January 2, 1986, for past services, Day Corp. granted Jan Bell, its president, 10,000 stock appreciation rights that are exercisable immediately and expire on January 2, 1989. On exercise, Bell is entitled to receive cash for the excess of the market price of the stock on the exercise date over the market price on the grant date. Bell did not exercise any of the rights during 1986. The market price of Day's stock was $30 on January 2, 1986, and $45 on December 31, 1986. As a result of the stock appreciation rights, Day should recognize compensation expense for 1986 of
   a. $0
   b. $50,000
   c. $150,000
   d. $300,000

1M87#44. Fay, Inc., was organized late in 1985 and began operations on January 1, 1986. Prior to the start of operations, the following costs were incurred:

Attorney's fees for incorporating $6,000
State incorporation filing fees 4,000

Fay amortizes organization costs over the maximum period allowable under GAAP. How much amortiza-
Selected Questions

1M86#41. Paul Company has a recent gross profit history of 40% of net sales. The following data are available from Paul’s accounting records for the three months ended March 31, 1986:

- Inventory at 1/1/86: $650,000
- Purchases: 3,200,000
- Net sales: 4,500,000
- Purchase returns: 75,000
- Freight-in: 50,000

Using the gross profit method, the estimated cost of goods sold for the three months ended March 31, 1986, should be

- a. $1,800,000
- b. $2,700,000
- c. $3,775,000
- d. $3,825,000

1N86#44. Rex Company’s officers’ compensation expense account had a balance of $448,000 at December 31, 1985, before any appropriate year-end adjustment relating to the following:

- No salary accrual was made for December 30-31, 1985. Salaries for the two-day period totaled $7,000.
- Bonuses to officers for 1985 were paid on January 31, 1986, in the total amount of $125,000.

The adjusted balance for officers’ compensation expense for the year ended December 31, 1985, should be

- a. $448,000
- b. $455,000
- c. $573,000
- d. $580,000

1N86#45. On January 1, 1985, Vick Company as lessee signed a ten-year noncancelable lease for a machine stipulating annual payments of $20,000. The first payment was made on January 1, 1985. Vick appropriately treated this transaction as a capital lease. The ten lease payments have a present value of $135,000 at January 1, 1985, based on implicit interest of 10%. For the year ended December 31, 1985, Vick should record interest expense of

- a. $0
- b. $6,500
- c. $11,500
- d. $13,500

1N86#46. Rapp Company purchased a machine on July 1, 1985, for $600,000. The machine has an estimated useful life of five years and a salvage value of $50,000.

1M87#45. On January 1, 1986, Kerr Company signed a ten-year noncancelable lease for a new machine, requiring $20,000 annual payments at the beginning of each year. The machine has a useful life of 15 years, with no salvage value. Title passes to Kerr at the lease expiration date. Kerr uses straight-line depreciation for all of its plant assets. Aggregate lease payments have a present value on January 1, 1986, of $126,000, based on an appropriate rate of interest. For 1986, Kerr should record depreciation (amortization) expense for the leased machine at

- a. $20,000
- b. $12,600
- c. $8,400
- d. $0

1M87#48. During 1986 Rex Company purchased marketable equity securities as a short-term investment. The cost and market value at December 31, 1986, were as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A — 100 shares</td>
<td>$2,800</td>
<td>$3,400</td>
</tr>
<tr>
<td>B — 1,000 shares</td>
<td>17,000</td>
<td>15,300</td>
</tr>
<tr>
<td>C — 2,000 shares</td>
<td>31,500</td>
<td>29,500</td>
</tr>
<tr>
<td></td>
<td>$51,300</td>
<td>$48,200</td>
</tr>
</tbody>
</table>

Rex sold 1,000 shares of Company B stock on January 31, 1987, for $15 per share, incurring $1,500 in brokerage commission and taxes. On the sale, Rex should report a realized loss of

- a. $300
- b. $1,800
- c. $2,000
- d. $3,500

1M87#52. Jason Company incurred the following infrequent losses during 1986:

- A major strike by employees shut down one of Jason’s factories. Shutdown losses totaled $180,000.
- A loss of $100,000 from writedown of plant and equipment to estimated realizable value.
- A loss of $150,000 on disposal of one of three similar factories.

In its 1986 income statement, how much should Jason report as total infrequent losses which are not considered extraordinary?

- a. $250,000
- b. $280,000
- c. $330,000
- d. $430,000

1N86#41. Paul Company has a recent gross profit history of 40% of net sales. The following data are available from Paul’s accounting records for the three months ended March 31, 1986:

- Inventory at 1/1/86: $650,000
- Purchases: 3,200,000
- Net sales: 4,500,000
- Purchase returns: 75,000
- Freight-in: 50,000

Using the gross profit method, the estimated cost of goods sold for the three months ended March 31, 1986, should be

- a. $1,800,000
- b. $2,700,000
- c. $3,775,000
- d. $3,825,000
$80,000. The machine is being depreciated from the date of acquisition by the 150% declining balance method. For the year ended December 31, 1985, Rapp should record depreciation expense on this machine of a. $180,000 
b. $120,000 
c. $ 90,000 
d. $ 78,000

1N86#47. Dell Corp. incurred the following costs during the year ended December 31, 1985:

Routine, on-going efforts to refine, enrich, or otherwise improve upon the qualities of an existing product $125,000
Design, construction, and testing of pre-production prototypes and models 110,000
Quality control during commercial production including routine testing of products 150,000
Laboratory research aimed at discovery of new knowledge 180,000

The total amount to be classified and expensed as research and development for 1985 is
a. $235,000 
b. $275,000 
c. $290,000 
d. $330,000

1N86#48. On January 1, 1984, Poe Company acquired the copyright to a book owned by Roberts for royalties of 15% of future book sales. Royalties are payable on September 30 for sales in January through June of the same year, and on March 31 for sales in July through December of the preceding year. During 1984 and 1985, Poe remitted royalty checks to Roberts as follows:

<table>
<thead>
<tr>
<th></th>
<th>March 31</th>
<th>September 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>$90,000</td>
<td>$24,000</td>
</tr>
<tr>
<td>1985</td>
<td>22,000</td>
<td>27,000</td>
</tr>
</tbody>
</table>

Poe’s sales of the Roberts book totaled $200,000 for the last half of 1985. In its 1985 income statement, Poe should report royalty expense relating to this book of
a. $46,000 
b. $49,000 
c. $51,000 
d. $57,000

1N86#49. Effective with the year ended December 31, 1985, Hall 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:

| Allowance for doubtful accounts, 1/1/85 | $25,000 |
| Provision for doubtful accounts during 1985 (2% on credit sales of $1,000,000) | 20,000 |
| Accounts written off, 11/30/85 | 20,500 |
| Estimated uncollectible accounts per aging, 12/31/85 | 22,000 |

After year-end adjustment, the doubtful accounts expense for 1985 should be
a. $22,000 
b. $20,500 
c. $20,000 
d. $17,500

1N86#50. Glen Apparel, Inc., leases and operates a retail store. The following information relates to the lease for the year ended December 31, 1985:

- The store lease, an operating lease, calls for fixed monthly rent of $1,500 the first day of each month, and additional rent equal to 6% of net sales over $300,000 per calendar year. Net sales for 1985 are $900,000.
- Additionally, Glen paid executory costs to the lessor for property taxes of $5,000 and insurance of $2,500.

For 1985 Glen’s expenses relating to the store lease are
a. $25,500 
b. $54,000 
c. $59,000 
d. $61,500

1N86#6. On January 1, 1985, Acar Co. agreed to grant its employees ten vested vacation days each year, with the provision that vacation days earned in a particular year could not be taken until the following year. For the year ended December 31, 1985, all five of Acar’s employees earned $100 per day each, and earned ten vacation days each. These vacation days were taken during the first half of 1986. Wage rates remained the same for 1986. In Acar’s 1985 income statement, how much expense should be reported for compensated absences?

a. $0 
b. $1,000 
c. $2,500 
d. $5,000

2N86#14. If one Canadian dollar can be exchanged for 90 cents of United States money, what fraction should be used to compute the indirect quotation of the exchange rate expressed in Canadian dollars?

a. 1.10/1 
b. 1/1.10 
c. 1/90 
d. .90/1
Selected Questions

1M86#42. Clay Company borrows money under various loan agreements involving notes discounted and notes requiring interest payments at maturity. During the year ended December 31, 1985, Clay paid interest totaling $100,000. Clay’s December 31 balance sheets included the following information:

<table>
<thead>
<tr>
<th></th>
<th>1984</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid interest</td>
<td>$23,500</td>
<td>$18,000</td>
</tr>
<tr>
<td>Interest payable</td>
<td>45,000</td>
<td>53,500</td>
</tr>
</tbody>
</table>

How much interest expense should Clay report for 1985?
   a. $ 86,000
   b. $ 97,000
   c. $103,000
   d. $114,000

1M86#43. On December 1, 1985, Kent Company leased office space for five years at a monthly rental of $30,000. On the same date Kent paid the lessor the following amounts:

| First month’s rent | $30,000 |
| Last month’s rent   | 30,000  |
| Security deposit (refundable at lease expiration) | 40,000 |
| Installation of new walls and offices | 180,000 |

Kent’s 1985 expense relating to utilization of the office space should be
   a. $30,000
   b. $33,000
   c. $60,000
   d. $70,000

1M86#44. Glen Company has the following data pertaining to the year ended December 31, 1985:

- Purchases | $450,000
- Beginning inventory | 170,000
- Ending inventory | 210,000
- Freight-in | 50,000
- Freight-out | 75,000

How much is the cost of goods sold for 1985?
   a. $385,000
   b. $460,000
   c. $485,000
   d. $540,000

1M86#45. Burg Company provides an incentive compensation plan granting its president a bonus equal to 10% of Burg’s income in excess of $220,000 after the bonus but before income tax. In 1985 Burg’s income before bonus and income tax was $550,000. The amount of the bonus for 1985 would be
   a. $50,000
   b. $36,300
   c. $33,000
   d. $30,000

1M86#46. Ward Company incurred research and development costs in 1985 as follows:

- Equipment acquired for use in various research and development projects | $975,000
- Depreciation on the above equipment | 135,000
- Materials used | 200,000
- Compensation costs of personnel | 500,000
- Outside consulting fees | 150,000
- Indirect costs appropriately allocated | 250,000

The total research and development costs charged in Ward’s 1985 income statement should be
   a. $850,000
   b. $1,085,000
   c. $1,235,000
   d. $1,825,000

1M86#47. On January 1, 1980, Ball, Inc., purchased a $1,000,000 ordinary life insurance policy on its president. The policy year and Ball’s accounting year coincide. Additional data are available for the year ended December 31, 1985:

- Cash surrender value, 1/1/85 | $43,500
- Cash surrender value, 12/31/85 | 54,000
- Annual advance premium paid 1/1/85 | 20,000
- Dividend received 7/1/85 | 3,000

Ball, Inc., is the beneficiary under the life insurance policy. How much should Ball report as life insurance expense for 1985?
   a. $ 6,500
   b. $ 9,500
   c. $17,000
   d. $20,000

1M86#48. Based on the aging of its accounts receivable at December 31, 1985, Terry Company determined that the net realizable value of the receivables at that date is $190,000. Additional information is as follows:

- Accounts receivable at 12/31/85 | $220,000
- Allowance for doubtful accounts at 1/1/85 — credit balance | 32,000
- Accounts written off as uncollectible at 9/30/85 | 24,000

Terry’s doubtful accounts expense for the year ended December 31, 1985, is
   a. $38,000
   b. $30,000
   c. $26,000
   d. $22,000

1M86#54. Rago Company takes a full year’s depreciation expense in the year of an asset’s acquisition,
and no depreciation expense in the year of disposition. Data relating to one of Rago's depreciable assets at December 31, 1984, are as follows:

<table>
<thead>
<tr>
<th>Acquisition year</th>
<th>1982</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$110,000</td>
</tr>
<tr>
<td>Residual value</td>
<td>20,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>72,000</td>
</tr>
<tr>
<td>Estimated useful life</td>
<td>5 years</td>
</tr>
</tbody>
</table>

Using the same depreciation method as used in 1982, 1983, and 1984, how much depreciation expense should Rago record in 1985 for this asset?

a. $12,000  
b. $13,000  
c. $22,000  
d. $24,000

1N85#55. Lane Company acquires copyrights from authors, paying advance royalties in some cases, and in others, paying royalties within 30 days of year end. Lane reported royalty expense of $375,000 for the year ended December 31, 1985. The following data are included in Lane's December 31 balance sheets:

<table>
<thead>
<tr>
<th></th>
<th>1984</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid royalties</td>
<td>$60,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Royalties payable</td>
<td>75,000</td>
<td>90,000</td>
</tr>
</tbody>
</table>

During 1985 Lane made royalty payments totaling

a. $350,000  
b. $370,000  
c. $380,000  
d. $400,000

1N85#56. On July 1, 1984, Clark Company borrowed 1,680,000 local currency units (LCU) from a foreign lender, evidenced by an interest bearing note due on July 1, 1985, which is denominated in the currency of the lender. The U.S. dollar equivalent of the note principal was as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/1/84 (date borrowed)</td>
<td>$210,000</td>
</tr>
<tr>
<td>12/31/84 (Clark's year end)</td>
<td>240,000</td>
</tr>
<tr>
<td>7/1/85 (date repaid)</td>
<td>280,000</td>
</tr>
</tbody>
</table>

In its income statement for 1985, what amount should Clark include as a foreign exchange gain or loss?

a. $70,000 gain.  
b. $70,000 loss.  
c. $40,000 gain.  
d. $40,000 loss.

1N85#60. Graf Company purchased a machine that was installed and placed in service on January 2, 1984, at a total cost of $120,000. Residual value was estimated at $20,000. The machine is being depreciated over ten years by the double declining balance method. For the year 1985, Graf should record depreciation expense of

a. $10,800  
b. $16,000  
c. $19,200  
d. $24,000

1N85#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>

1N85#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

1N85#40. In January 1984 Huff Mining Corporation purchased a mineral mine for $3,600,000 with remov-able 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

1N85#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>
</tr>
</thead>
<tbody>
<tr>
<td>at 1/1/84 — credit balance</td>
</tr>
<tr>
<td>Accounts written off as uncollectible during 1984</td>
</tr>
<tr>
<td>Accounts receivable at 12/31/84</td>
</tr>
</tbody>
</table>
Selected Questions

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

1M85#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

1M85#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

1M85#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

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. $33,000
c. $30,600
d. $0
**Accounting Practice**

**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:

<table>
<thead>
<tr>
<th>LCU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation of equipment (related assets were purchased January 1, 1982)</td>
</tr>
<tr>
<td>Provision for doubtful accounts</td>
</tr>
<tr>
<td>Rent</td>
</tr>
</tbody>
</table>

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 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#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>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid royalties</td>
<td>$55,000</td>
</tr>
<tr>
<td>Royalties payable</td>
<td>80,000</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. $395,000
- 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:

- January 1, 1983 | $25 |
- December 31, 1983 | 30 |
- December 31, 1984 | 40 |

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:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</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
Selected Questions

1N84#46. Wayne, Inc., incurred the following costs during the year ended December 31, 1983:

Laboratory research aimed at discovery of new knowledge $150,000
Radical modification to the formulation of a chemical product 125,000
Research and development costs reimbursable under a contract to perform research and development for Apex Chemicals, Inc. 350,000
Testing for evaluation of new products 250,000

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

1N84#49. 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

1N84#51. 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

1N84#52. 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

1N84#53. 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

1N84#54. 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 — credit balance 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

1N84#55. 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 Sep-
Accounting Practice

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>
<tr>
<td></td>
<td>$21,000</td>
</tr>
<tr>
<td></td>
<td>19,000</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#35. The following expenses were among those incurred by Sayre Company during 1983:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting and legal fees</td>
<td>$160,000</td>
</tr>
<tr>
<td>Interest</td>
<td>60,000</td>
</tr>
<tr>
<td>Loss on sale of office equipment</td>
<td>25,000</td>
</tr>
<tr>
<td>Rent for office space</td>
<td>200,000</td>
</tr>
</tbody>
</table>

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. 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#38. 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:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory at 1/1/83</td>
<td>$550,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Net sales</td>
<td>4,000,000</td>
</tr>
</tbody>
</table>

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#39. 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:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research and development</td>
<td>$365,000</td>
</tr>
<tr>
<td>departmental costs</td>
<td></td>
</tr>
<tr>
<td>Materials and supplies consumed</td>
<td>110,000</td>
</tr>
<tr>
<td>Compensation paid to research consultants</td>
<td>200,000</td>
</tr>
<tr>
<td></td>
<td>$675,000</td>
</tr>
</tbody>
</table>

How much of the costs incurred should Mann charge to expense in 1983?

a. $675,000  
b. $475,000  
c. $225,000  
d. $0
Selected Questions

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, 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>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$120,000</td>
</tr>
<tr>
<td>Loss on disposal of noncurrent</td>
<td>80,000</td>
</tr>
<tr>
<td>investment</td>
<td></td>
</tr>
<tr>
<td>Writedown of plant and equipment</td>
<td>60,000</td>
</tr>
<tr>
<td>to estimated realizable value</td>
<td></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 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

1N83#10. Frye Company incurred research and development costs in 1982 as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment acquired for use in</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>research and development projects</td>
<td></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 $40,000 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#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

1M83#18. Paulson Company had inventories at the beginning and end of 1982 as follows:

<table>
<thead>
<tr>
<th>Description</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
2M83#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

C. Provision for Income Tax

1M87#46. Purl Corporation’s income statement for the year ended December 31, 1986, shows the following:

Income before income tax and extraordinary item $900,000
Gain on life insurance coverage — included in the above $900,000 income amount 100,000
Extraordinary item — loss due to earthquake damage 300,000

Purl’s tax rate for 1986 is 40%. How much should be reported as the provision for income tax in Purl’s 1986 income statement?

a. $200,000
b. $240,000
c. $320,000
d. $360,000

2M87
Items 4 through 11 are based on the following data:

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

**BALANCE SHEETS**
*December 31, 1986*

<table>
<thead>
<tr>
<th>Assets</th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$150,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>190,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>430,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Property, plant, and equipment (net)</td>
<td>365,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Investment in Sub (equity method)</td>
<td>315,000</td>
<td>—</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,110,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

**Liabilities and Stockholders’ Equity**

| Current liabilities | $100,000 | $60,000 |
| Accrued liabilities | 30,000 | 20,000 |
| Total current liabilities | 130,000 | 80,000 |
| Stockholders’ equity | | |
| Common stock ($10 par) | 220,000 | 30,000 |
| Additional paid-in capital | 140,000 | 100,000 |
| Retained earnings | 620,000 | 140,000 |
| Total stockholders’ equity | 980,000 | 270,000 |
| Total liabilities and stockholders’ equity | $1,110,000 | $350,000 |

**INCOME STATEMENTS**
*For the Year Ended December 31, 1986*

<table>
<thead>
<tr>
<th></th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,000,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>770,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>230,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>130,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>100,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Equity in earnings of Sub</td>
<td>25,000</td>
<td>—</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>125,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>40,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$85,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

**Additional information:**

- On January 1, 1986, Par purchased for $300,000 all of Sub’s $10 par, voting common stock. On January 1, 1986, the fair value of Sub’s assets and liabilities equaled their carrying amount of $330,000 and $80,000, respectively. Par’s policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.

- During 1986, Par and Sub paid cash dividends of $50,000 and $10,000, respectively. For tax purposes, Par receives the 100% exclusion for dividends received from Sub.

- There were no intercompany transactions except for Par’s receipt of dividends from Sub, and Par’s recording of its share of Sub’s earnings.
Selected Questions

- On June 30, 1986, Par issued 2,000 shares of common stock for $17 per share. There were no other changes in either Par's or Sub's common stock during 1986.
- Both Par and Sub paid income taxes at the rate of 40%.

11. In Par's 1986 income statement, what amount of deferred income taxes on Par's equity in Sub's earnings should be included in Par's provision for income taxes?
   a. $0
   b. $2,000
   c. $10,000
   d. $12,000

2N86#19. Lobo Corp. incurred the following expenses which it treated differently in computing accounting income and taxable income:

- Premiums on officers' life insurance, under which the corporation is the beneficiary: $5,000
- Estimated future warranty costs: $60,000

The timing differences amount to
   a. $0
   b. $5,000
   c. $60,000
   d. $65,000

2N86#20. For the year ended December 31, 1985, Rosa Corp.'s pretax accounting income comprised the following:

<table>
<thead>
<tr>
<th>Income from operations</th>
<th>Rent income from tenant:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Received in 1985</td>
</tr>
<tr>
<td></td>
<td>$26,000</td>
</tr>
<tr>
<td></td>
<td>Portion applicable to 1986 rent</td>
</tr>
<tr>
<td></td>
<td>2,000</td>
</tr>
<tr>
<td>Pretax accounting income</td>
<td>$224,000</td>
</tr>
</tbody>
</table>

Rosa's income tax rate is 40%. Rosa's 1985 income tax expense should be
   a. $80,000
   b. $89,600
   c. $90,400
   d. $91,200

$500,000. The following items are treated differently on the tax return and on the accounting records:

<table>
<thead>
<tr>
<th>Item</th>
<th>Tax return</th>
<th>Accounting records</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent income</td>
<td>$35,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>140,000</td>
<td>110,000</td>
</tr>
<tr>
<td>Premiums on officers' life insurance</td>
<td>None</td>
<td>45,000</td>
</tr>
</tbody>
</table>

Assume that Kemp's tax rate for 1985 is 40%.

49. What is the current portion of Kemp's total income tax expense for 1985?
   a. $218,000
   b. $200,000
   c. $196,000
   d. $178,000

50. What is the deferred portion of Kemp's total income tax expense for 1985?
   a. $4,000
   b. $12,000
   c. $20,000
   d. $22,000

1N85#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:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on municipal bonds</td>
<td>$60,000</td>
</tr>
<tr>
<td>Lower depreciation per books</td>
<td>140,000</td>
</tr>
<tr>
<td></td>
<td>$200,000</td>
</tr>
</tbody>
</table>

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

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

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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

2N83#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

2N83#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
- Taxable income, per Form 1120 300,000
- 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

D. Recurring Versus Nonrecurring Transactions and Events

1M87#49. On December 31, 1986, King Company appropriately changed to the FIFO cost method from the
Selected Questions

weighted-average cost method for financial statement and income tax purposes. The change will result in a $350,000 increase in the beginning inventory at January 1, 1986. Assuming a 40% income tax rate, the cumulative effect of this accounting change reported for the year ended December 31, 1986, is

- a. $350,000
- b. $210,000
- c. $140,000
- d. $0

1M87#51. On January 1, 1986, Kern Company entered into an agreement to sell the assets and product line of its Zeno Division, considered a segment of the business. The sale was consummated on December 31, 1986, and resulted in a gain on disposition of $800,000. The division’s operations resulted in losses before income tax of $450,000 in 1986 and $250,000 in 1985. Kern’s income tax rate is 40% for both years. In a comparative statement of income for 1986 and 1985, as components under the caption Discontinued Operations, Kern should report gain (loss) amounting to $350,000.

<table>
<thead>
<tr>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $210,000</td>
<td>($150,000)</td>
</tr>
<tr>
<td>b. $210,000</td>
<td>$0</td>
</tr>
<tr>
<td>c. ($270,000)</td>
<td>($150,000)</td>
</tr>
<tr>
<td>d. ($270,000)</td>
<td>$0</td>
</tr>
</tbody>
</table>

1M87#59. Hull Company is indebted to Apex under a $500,000, 12%, three-year note dated December 31, 1984. Because of Hull’s financial difficulties developing in 1986, Hull owed accrued interest of $60,000 on the note at December 31, 1986. Under a troubled debt restructuring, on December 31, 1986, Apex agreed to settle the note and accrued interest for a tract of land having a fair value of $450,000. Hull’s acquisition cost of the land is $360,000. Ignoring income taxes, on its 1986 income statement Hull should report as a result of the troubled debt restructuring $300,000.

Other income

- a. $200,000
- b. $140,000
- c. $ 90,000
- d. $ 90,000

Extraordinary gain

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

2N86

Items 7 through 10 are based on the following data:

When Key Co. commenced business operations on January 1, 1983, the following assets were among those acquired at that date:

Real estate

- Cost of parcel of land $ 20,000
- Cost of razing old structure 3,000
- Title insurance and legal fees pertaining to land acquisition 5,000
- Architect’s fees 30,000
- Cost of constructing new building 600,000

Machinery

- Cost 100,000
- Residual value 10,000
- Estimated useful life (double-declining-balance method) 4 years

In 1985, Key incurred the following losses:

- Foreign exchange loss because of major devaluation of foreign currency $ 17,000
- Effects of a strike against Key’s major supplier 120,000

Also during 1985, the following gains were recognized:

- Income tax benefit arising from operating loss carryforward $ 80,000
- Gain on sale of real estate used in operations 300,000

9. For the year ended December 31, 1985, the extraordinary losses, before income tax considerations, amounted to

- a. $0
- b. $ 17,000
- c. $120,000
- d. $137,000

10. For the year ended December 31, 1985, the extraordinary gains, before income tax considerations, amounted to

- a. $0
- b. $ 80,000
- c. $300,000
- d. $380,000

1M86#41. Colt, Inc., is indebted to Kent under an $800,000, 10%, four-year note dated December 31, 1982. Annual interest of $80,000 was paid on December 31, 1983 and 1984. During 1985 Colt experienced financial difficulties and is likely to default unless concessions are made. On December 31, 1985, Kent agreed to restructure the debt as follows:

- Interest of $80,000 for 1985, due December 31, 1985, was made payable December 31, 1986.
- Interest for 1986 was waived.
- The principal amount was reduced to $700,000.

Assuming an income tax rate of 40%, how much should Colt report as extraordinary gain in its income statement for the year ended December 31, 1985?

- a. $0
- b. $ 60,000
- c. $100,000
- d. $108,000

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Accounting Practice

**1N85#48.** Rice, Inc., incurred the following losses, net of applicable taxes, for the year ended December 31, 1984:

- 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. $300,000

**1N85#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

**1N86#59.** On October 1, 1985, Mann Company approved a formal plan to sell Mill Division, considered a segment of the business. The sale will occur on March 31, 1986. The division had operating income of $500,000 for the quarter ended December 31, 1985, but expects to incur an operating loss of $100,000 for the first quarter of 1986. Mann also estimates that it will incur a loss of $750,000 on the sale of the division’s assets. Mann’s tax rate for 1985 is 40%. In its income statement for the year ended December 31, 1985, how much gain or loss should Mann report on disposal of Mill Division?

a. $210,000 loss.
b. $300,000 gain.
c. $350,000 loss.
d. $300,000 gain.

**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

**1N84#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 restructure in its income statement for the year ended December 31, 1983?

a. $0
b. $60,000
c. $100,000
d. $144,000

AP-72
Selected Questions

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. $840,000
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 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 restructure 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.

E. Accounting Changes

1M87#47. On January 1, 1984, Bray Company purchased for $240,000 a machine with a useful life of ten years and no salvage value. The machine was depreciated by the double declining balance method and the carrying amount of the machine was $153,600 on December 31, 1985. Bray changed retroactively to the straight-line method on January 1, 1986. Bray can justify the change. What should be the depreciation expense on this machine for the year ended December 31, 1986?

a. $15,360
b. $19,200
c. $24,000
d. $30,720

2N86

Items 11 and 12 are based on the following data:

Ali Co. bought a machine on January 1, 1981, for $24,000, at which time it had an estimated useful life of eight years, with no residual value. Straight-line de-
Accounting Practice

precipation is used for all of Ali's depreciable assets. On January 1, 1983, the machine's estimated useful life was determined to be only six years from the acquisition date. Accordingly, the appropriate accounting change was made in 1983. The direct effects of this change were limited to the effect on depreciation and the related provision for income tax. Ali's income tax rate was 40% in all the affected years.

11. In Ali's 1983 financial statements, how much should be reported as the cumulative effect on prior years because of the change in the estimated useful life of the machine?
   a. $0  
   b. $1,200  
   c. $2,000  
   d. $2,800

12. For the year ended December 31, 1985, how much depreciation expense should Ali record for this machine?
   a. $0  
   b. $2,700  
   c. $4,500  
   d. $6,300

1M86#57. During 1985 Kerr 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 1985 to reflect the change in estimate. If the change had been made in 1984, accumulated depreciation would have been $800,000 at December 31, 1984, instead of $600,000. As a result of this change, the 1985 depreciation expense was $50,000 greater. The income tax rate was 40% in both years. What should be reported in Kerr's income statement for the year ended December 31, 1985, as the cumulative effect on prior years of changing the estimated useful life of the machinery?
   a. $0  
   b. $120,000  
   c. $150,000  
   d. $200,000

1M86#58. On January 1, 1985, Poe Construction, Inc., changed to the percentage-of-completion method of income recognition for financial statement reporting but not for income tax reporting. Poe can justify this change in accounting principle. As of December 31, 1984, Poe compiled data showing that income under the completed contract method aggregated $700,000. If the percentage-of-completion method had been used, the accumulated income through December 31, 1984, would have been $880,000. Assuming an income tax rate of 40% for all years, the cumulative effect of this accounting change should be reported by Poe in the 1985
   a. Retained earnings statement as a $180,000 credit adjustment to the beginning balance.
   b. Income statement as a $180,000 credit.
   c. Retained earnings statement as a $108,000 credit adjustment to the beginning balance.
   d. Income statement as a $108,000 credit.

1M85#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

1M85#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.

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
Selected Questions

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.

1N84#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

2M83#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

F. Earnings Per Share

1M87#58. Dunn, Inc., had 200,000 shares of $20 par common stock and 20,000 shares of $100 par, 6%, cumulative, convertible preferred stock outstanding for the entire year ended December 31, 1986. The preferred stock was not a common stock equivalent at time of issue, and each share is convertible into five shares of common stock. Dunn's net income for 1986 was $840,000. For the year ended December 31, 1986, the fully diluted earnings per share is

a. $2.40
b. $2.80
c. $3.60
d. $4.20

2M87 Items 4 through 11 are based on the following data:

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

BALANCE SHEETS
December 31, 1986

<table>
<thead>
<tr>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$150,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>190,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>430,000</td>
</tr>
<tr>
<td>Property, plant, and equipment (net)</td>
<td>365,000</td>
</tr>
<tr>
<td>Investment in Sub (equity method)</td>
<td>315,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,110,000</td>
</tr>
</tbody>
</table>

| **Liabilities and Stockholders' Equity** |
| Current liabilities |           |
| Accounts payable | $100,000 | $60,000 |
| Accrued liabilities | 30,000 | 20,000 |
| Total current liabilities | 130,000 | 80,000 |
| Stockholders' equity |           |
| Common stock ($10 par) | 220,000 | 30,000 |
| Additional paid-in capital | 140,000 | 100,000 |
| Retained earnings | 620,000 | 140,000 |
| Total stockholders' equity | 980,000 | 270,000 |
| Total liabilities and stockholders' equity | $1,110,000 | $350,000 |

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INCOME STATEMENTS
For the Year Ended December 31, 1986

<table>
<thead>
<tr>
<th></th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,000,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>770,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>230,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>130,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>100,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Equity in earnings of Sub</td>
<td>25,000</td>
<td>—</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>125,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>40,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 85,000</td>
<td>$ 30,000</td>
</tr>
</tbody>
</table>

Additional information:

- On January 1, 1986, Par purchased for $300,000 all of Sub’s $10 par, voting common stock. On January 1, 1986, the fair value of Sub’s assets and liabilities equaled their carrying amount of $330,000 and $80,000, respectively. Par’s policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.

- During 1986, Par and Sub paid cash dividends of $50,000 and $10,000, respectively. For tax purposes, Par receives the 100% exclusion for dividends received from Sub.

- There were no intercompany transactions except for Par’s receipt of dividends from Sub, and Par’s recording of its share of Sub’s earnings.

- On June 30, 1986, Par issued 2,000 shares of common stock for $17 per share. There were no other changes in either Par’s or Sub’s common stock during 1986.

- Both Par and Sub paid income taxes at the rate of 40%.

8. In computing the consolidated earnings per share for Par and its subsidiary, Sub, the number of shares used should be
   a. 25,000  
   b. 24,000  
   c. 22,000  
   d. 21,000  

2N86#17. At December 31, 1985 and 1984, Gow Corp. had 100,000 shares of common stock and 10,000 shares of 5%, $100 par value cumulative preferred stock outstanding. No dividends were declared on either the preferred or common stock in 1985 or 1984. Net income for 1985 was $1,000,000. For 1985, earnings per common share amounted to
   a. $10.00  
   b. $ 9.50  
   c. $ 9.00  
   d. $ 5.00  

2N86#18. Newt Corp. had earnings per share of $12.00 for 1985, before taking any dilutive securities into consideration. No conversion or exercise of dilutive securities took place in 1985. However, possible conversion of convertible preferred stock, a common stock equivalent, would have reduced earnings per share to $11.90. The effect of possible exercise of common stock warrants would have reduced earnings per share by an additional $0.05. For 1985, what is the maximum amount that Newt may report as a single presentation of earnings per share?
   a. $12.00  
   b. $11.95  
   c. $11.90  
   d. $11.85  

1M86#51. On December 31, 1984, Case, Inc., had 300,000 shares of common stock issued and outstanding. Case issued a 10% stock dividend on July 1, 1985. On October 1, 1985, Case purchased 24,000 shares of its common stock for treasury, and recorded the purchase by the cost method. What is the number of shares that should be used in computing earnings per share for the year ended December 31, 1985?
   a. 306,000  
   b. 309,000  
   c. 324,000  
   d. 330,000  

1M86#52. Rhan Company had 200,000 shares of common stock issued and outstanding at December 31, 1984. No common stock was issued during 1985. On January 1, 1985, Rhan issued 50,000 shares of convertible preferred stock. This stock is convertible into 100,000 shares of common stock, and is not considered a common stock equivalent. During 1985, Rhan paid $300,000 cash dividends on the preferred stock. Net income for the year ended December 31, 1985, was $750,000. What should be Rhan’s primary earnings per share for 1985?
   a. $1.50  
   b. $2.25  
   c. $2.50  
   d. $3.75  

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Selected Questions

1M85. 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>Outstanding shares of:</td>
<td></td>
<td></td>
</tr>
<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 stock</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>10% convertible bonds, convertible into 20,000 shares of common stock</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

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

1M84#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
C. Nonmonetary Transactions

2M87#18. On September 1, 1986, Ron Corp. issued 1,000 shares of its $25 par treasury common stock for a parcel of land to be held for a future plant site. The treasury shares were acquired by Ron at a cost of $30 per share. Ron's common stock had a fair market value of $40 per share on September 1, 1986. Ron received $5,000 from the sale of scrap when an existing structure on the site was razed. At what amount should the land be carried?
   a. $40,000
   b. $35,000
   c. $30,000
   d. $25,000

1N86#52. On December 2, 1985, Parr Company traded in a used delivery truck with a carrying amount of $5,400 for a new delivery truck having a list price of $16,000, and paid a cash difference of $7,500 to the dealer. The used truck had a fair value of $6,000 on the date of the exchange.

At what amount should the new truck be recorded on Parr's books?
   a. $10,600
   b. $12,900
   c. $13,500
   d. $16,000

1N86#53. Caine Motor Sales exchanged a car from its inventory for a computer to be used as a long-term asset. The following information relates to this exchange that took place on July 31, 1986:

<table>
<thead>
<tr>
<th>Carrying amount of the car</th>
<th>$30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed selling price of the car</td>
<td>45,000</td>
</tr>
<tr>
<td>Fair value of the computer</td>
<td>43,000</td>
</tr>
<tr>
<td>Cash difference paid by Caine</td>
<td>5,000</td>
</tr>
</tbody>
</table>

On July 31, 1986, what amount of profit should Caine recognize on this exchange?
   a. $0
   b. $8,000
   c. $10,000
   d. $13,000

2M86#11. Clay Township owned an idle parcel of real estate consisting of land and a factory building. Clay gave title to this realty to Wolf Co. as an incentive for Wolf to establish manufacturing operations in the Township. Wolf paid nothing for this realty, which had a fair market value of $200,000 at the date of the grant. Wolf should record this nonmonetary transaction as a
   a. Memo entry only.
   b. Credit to retained earnings for $200,000.
   c. Credit to extraordinary income for $200,000.
   d. Credit to additional paid-in capital for $200,000.

1M85#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

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
   c. $320,000
   d. $440,000

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—</td>
<td></td>
</tr>
<tr>
<td>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
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

1N83#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.

1N83#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?
 a. $11,000
b. $11,500
c. $12,000
d. $12,500

D. Interim Financial Statements

2M87#12. In January 1987, Noll Corp. paid property taxes of $20,000 covering the calendar year 1987. Also in January 1987, Noll estimated that its year-end bonuses to factory workers would amount to $80,000 for 1987. In Noll’s quarterly income statement for the three months ended March 31, 1987, what is the total amount of expense relating to these two items that should be reported?
 a. $25,000
b. $20,000
c. $5,000
d. $0

1N86#54. In January 1986, Pine Company paid property taxes of $80,000 covering the calendar year 1986. Also in January 1986 Pine estimated that its year-end bonuses to executives would amount to $320,000 for 1986. What is the total amount of expense relating to these two items that should be reflected in Pine’s quarterly income statement for the three months ended June 30, 1986?
 a. $100,000
b. $80,000
c. $20,000
d. $0

2M86#12. On July 1, 1985, Dolan Corp. incurred an extraordinary loss of $300,000, net of income tax saving. Dolan’s operating income for the full year ending December 31, 1985, was expected to be $500,000. In Dolan’s income statement for the quarter ended September 30, 1985, how much of this extraordinary loss should be disclosed separately?
 a. $300,000
b. $150,000
c. $75,000
d. $0

1N85#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

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
Accounting Practice

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

1M84#47. 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

2M83#17. 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

E. Historical Cost, Constant Dollar Accounting, and Current Cost

1M87#57. Details of Poe Corp.'s plant assets at December 31, 1986, 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>1984</td>
<td>30</td>
<td>$200,000</td>
<td>$280,000</td>
</tr>
<tr>
<td>1985</td>
<td>20</td>
<td>60,000</td>
<td>76,000</td>
</tr>
<tr>
<td>1986</td>
<td>10</td>
<td>80,000</td>
<td>88,000</td>
</tr>
</tbody>
</table>

Poe 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 plant assets. In Poe's voluntary supplementary information restated into current cost, the net current cost (after accumulated depreciation) of the plant assets at December 31, 1986, should be stated as

a. $364,000
b. $336,000
c. $260,000
d. $232,000

1M86#60. Kerr Company purchased a machine for $115,000 on January 1, 1985, the company's first day of operations. At the end of the year, the current cost of the machine was $125,000. The machine has no salvage value, a five-year life, and is depreciated by the straight line method. For the year ended December 31, 1985, the amount of the current cost depreciation expense which would appear in supplementary current cost financial statements is:

a. $14,000
b. $23,000
c. $24,000
d. $25,000

2M86#1. At both the beginning and end of the year, Lang Co.'s monetary assets exceeded monetary liabilities by $3,000,000. On January 1, the general price level was 125. On December 31, the general price level was 150. How much was Lang's purchasing power loss on net monetary items during the year?

a. $0
b. $600,000
c. $750,000
d. $1,125,000

2M86#10. The following items were among those that appeared on Roth Co.'s books at the beginning and end of the year:

- Demand bank deposits: $500,000
- Net long-term receivables: 300,000
- Deferred income tax charges: 100,000

In preparing constant dollar financial statements, how much should Roth classify as monetary assets?

a. $500,000
b. $600,000
c. $800,000
d. $900,000

AP-80
Selected Questions

1N85#51. Lewis Company was formed on January 1, 1983. Selected balances from the historical cost balance sheet at December 31, 1984, were as follows:

<table>
<thead>
<tr>
<th>Land (purchased in 1983)</th>
<th>Investment in nonconvertible bonds (purchased in 1983, and expected to be held to maturity)</th>
<th>Long-term debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>$120,000</td>
<td>$60,000</td>
<td>$88,000</td>
</tr>
<tr>
<td>$66,000</td>
<td></td>
<td>$80,000</td>
</tr>
</tbody>
</table>

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 at:

<table>
<thead>
<tr>
<th>Land</th>
<th>Investment</th>
<th>Long-term debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$120,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>b.</td>
<td>$120,000</td>
<td>$66,000</td>
</tr>
<tr>
<td>c.</td>
<td>$132,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>d.</td>
<td>$132,000</td>
<td>$66,000</td>
</tr>
</tbody>
</table>

1M85#54. 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>20,000</td>
</tr>
<tr>
<td>1,060,000</td>
<td></td>
</tr>
<tr>
<td>Production during 1984</td>
<td>90,000</td>
</tr>
<tr>
<td>5,580,000</td>
<td></td>
</tr>
<tr>
<td>Inventory, 12/31/84</td>
<td>30,000</td>
</tr>
<tr>
<td>6,640,000</td>
<td></td>
</tr>
<tr>
<td>1,890,000</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>80,000</td>
</tr>
<tr>
<td>4,750,000</td>
<td></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

1N86#51. Kay Company is preparing its December 31, 1985, financial statements and must determine the proper accounting treatment for the following situations:

- On December 30, 1985, Kay received a $200,000 offer for its ROGO patent. Kay’s management is considering whether or not to sell the patent. The offer expires on February 28, 1986. The patent has a carrying amount of $130,000 at December 31, 1985.

2N84 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 100.

F. Gain Contingencies

1N86#51. Kay Company is preparing its December 31, 1985, financial statements and must determine the proper accounting treatment for the following situations:

- On December 30, 1985, Kay received a $200,000 offer for its ROGO patent. Kay’s management is considering whether or not to sell the patent. The offer expires on February 28, 1986. The patent has a carrying amount of $130,000 at December 31, 1985.
• On December 31, 1985, Kay, as lessee under an operating lease, sublet a building for a three-year period at $150,000 annual rental. Kay’s annual rental expense for the same period will be $110,000.

Assume an income tax rate of 40%. In its 1985 income statement, Kay should recognize increased net income of
a. $0
b. $66,000
c. $70,000
d. $72,000

1N85#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

1M85#58. In May 1981 West Company filed suit against Brown, Inc., seeking $850,000 damages for patent infringement. A court verdict in November 1984 awarded West $600,000 in damages, but Brown’s appeal is not expected to be decided before 1986. West’s counsel believes it is probable that West will be successful against Brown for an estimated amount in the range between $300,000 and $450,000, with $400,000 considered the most likely amount. What amount should West record as income from lawsuit in the year ended December 31, 1984?

a. $0
b. $300,000
c. $400,000
d. $600,000

2M84#2. On January 3, 1983, Palo Corp. owned a machine that had cost $50,000, on which the accumulated depreciation was $40,000, and which had a fair market value of $80,000. On January 4, 1983, this machine was irreparably damaged by Seco Corp. and became worthless. In October 1983, a court awarded damages of $80,000 against Seco, in favor of Palo. At December 31, 1983, the final outcome of this case was awaiting appeal, and was therefore uncertain. However, in the opinion of Palo’s attorney, Seco’s appeal will be denied. At December 31, 1983, how much should Palo accrue for this gain contingency?

a. $0
b. $10,000
c. $70,000
d. $80,000

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

G. Segments and Lines of Business

1M87#56. Clay Company has three lines of business, each of which was determined to be a reportable segment. Company sales aggregated $1,500,000 in 1986, of which Segment No. 1 contributed 40%. Traceable costs were $350,000 for Segment No. 1 out of a total of $1,000,000 for the company as a whole. For internal reporting, Clay allocates common costs of $300,000 based on the ratio of a segment’s income before common costs to the total income before common costs. In its 1986 financial statements, how much should Clay report as operating profit for Segment No. 1?

a. $250,000
b. $200,000
c. $130,000
d. $100,000

1N86#55. Colt Company has four manufacturing divisions, each of which has been determined to be a reportable segment. Common operating costs are appropriately allocated on the basis of each division’s sales in relation to Colt’s aggregate sales. Colt’s Delta division accounted for 40% of Colt’s total sales in 1985. For the year ended December 31, 1985, Delta had sales of $2,000,000 and traceable operating costs of $1,200,000. In 1985 Colt incurred operating costs of $200,000 that were not directly traceable to any of the divisions. In addition, Colt incurred interest expense of $160,000 in 1985. In reporting supplementary segment information, how much should be shown as Delta’s operating profit for 1985?

a. $800,000
b. $750,000
c. $720,000
d. $656,000

2M86#2. The following information pertains to Hay Corp. and its divisions for the year ended December 31, 1985:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales to unaffiliated customers</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Intersegment sales of products similar to those sold to unaffiliated customers</td>
<td>$300,000</td>
</tr>
<tr>
<td>Interest earned on loans to mother industry segments</td>
<td>$20,000</td>
</tr>
</tbody>
</table>
**Selected Questions**

Hay and all of its divisions are engaged solely in manufacturing operations. Hay has a reportable segment if that segment’s revenue exceeds

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>b.</td>
<td>$102,000</td>
<td></td>
</tr>
<tr>
<td>c.</td>
<td>$130,000</td>
<td></td>
</tr>
<tr>
<td>d.</td>
<td>$132,000</td>
<td></td>
</tr>
</tbody>
</table>

**1N85#59.** Evan, Inc., discloses supplemental industry segment information. The following data are available for 1984:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales (in $1,000)</th>
<th>Traceable expenses (in $1,000)</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?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$125,000</td>
</tr>
<tr>
<td>b.</td>
<td>$80,000</td>
</tr>
<tr>
<td>c.</td>
<td>$65,000</td>
</tr>
<tr>
<td>d.</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

**1N85#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 (in $100,000)</th>
<th>Traceable costs (in $100,000)</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?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$162,000</td>
</tr>
<tr>
<td>b.</td>
<td>$210,000</td>
</tr>
<tr>
<td>c.</td>
<td>$312,000</td>
</tr>
<tr>
<td>d.</td>
<td>$360,000</td>
</tr>
</tbody>
</table>

**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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$40,000</td>
</tr>
<tr>
<td>b.</td>
<td>$100,000</td>
</tr>
<tr>
<td>c.</td>
<td>$300,000</td>
</tr>
<tr>
<td>d.</td>
<td>$340,000</td>
</tr>
</tbody>
</table>

**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?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$500,000</td>
</tr>
<tr>
<td>b.</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>c.</td>
<td>$1,220,000</td>
</tr>
<tr>
<td>d.</td>
<td>$1,400,000</td>
</tr>
</tbody>
</table>

**1M84#53.** Eller Company discloses supplemental industry segment information. The following data are available for 1983:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales (in $100,000)</th>
<th>Traceable costs (in $100,000)</th>
<th>Allocable costs (in $100,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>R</td>
<td>$300,000</td>
<td>$240,000</td>
<td>?</td>
</tr>
<tr>
<td>S</td>
<td>400,000</td>
<td>220,000</td>
<td>?</td>
</tr>
<tr>
<td>T</td>
<td>200,000</td>
<td>140,000</td>
<td>?</td>
</tr>
<tr>
<td></td>
<td>$900,000</td>
<td>$600,000</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

Costs are appropriately allocated based on the ratio of a segment’s income before allocable costs to total income before allocable costs. What is the operating profit for segment R for 1983?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$20,000</td>
</tr>
<tr>
<td>b.</td>
<td>$24,000</td>
</tr>
<tr>
<td>c.</td>
<td>$56,000</td>
</tr>
<tr>
<td>d.</td>
<td>$48,000</td>
</tr>
</tbody>
</table>

**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

H. Employee Benefits

1M87#50. Ruhl Company grants all employees two weeks paid vacation for each full year of employment. Unused vacation time can be accumulated and carried forward to succeeding years, and will be paid at the salaries in effect when vacations are taken or when employment is terminated. There was no employee turnover in 1986. Additional information relating to the year ended December 31, 1986, is as follows:

- Liability for accumulated vacations at 12/31/85: $25,000
- Pre-1986 accrued vacations taken from 1/1/86 to 9/30/86: 15,000
- Vacations earned for work in 1986 (adjusted to current rates): 20,000

Ruhl granted a 10% salary increase to all employees on October 1, 1986, its annual salary increase date. For the year ended December 31, 1986, Ruhl should report vacation pay expense of:
   a. $21,000
   b. $22,500
   c. $30,000
   d. $35,000

1N85#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

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:

- Total salaries: $750,000
- Total employee deposits made: 25,000

What amount should Lenox report as retirement savings plan expense for 1983?
   a. $0
   b. $12,500
   c. $18,750
   d. $25,000

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 year ended December 31, 1982, Lucro's income was $110,000 before deducting the bonus and income taxes. Lucro estimated its income tax expense at $40,000 for 1982. How much bonus should Lucro pay the general manager for 1982?
   a. $0
   b. $7,000
   c. $10,000
   d. $11,000

I. Analysis of Financial Statements

1M87

Items 54 and 55 are based on the following data:

Drew Company
Selected Financial Data

<table>
<thead>
<tr>
<th></th>
<th>As of December 31, 1986</th>
<th>As of December 31, 1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$75,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>225,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>270,000</td>
<td>210,000</td>
</tr>
<tr>
<td>Short-term marketable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land and building</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Mortgage payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>current portion</td>
<td>30,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>120,000</td>
<td>110,000</td>
</tr>
<tr>
<td>and accrued liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term notes payable</td>
<td>50,000</td>
<td>70,000</td>
</tr>
</tbody>
</table>

Year Ended December 31,

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,500,000</td>
<td>$1,300,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>900,000</td>
<td>800,000</td>
</tr>
</tbody>
</table>

54. Drew's quick (acid test) ratio as of December 31, 1986, is:
   a. 3.6 to 1
   b. 3.1 to 1
   c. 2.0 to 1
   d. 1.7 to 1

55. Based on a business year consisting of 300 days, what was the number of days' sales in average inventory for 1986?
   a. 80
   b. 70
   c. 54
   d. 48

AP-84
Selected Questions

2M87

Items 4 through 11 are based on the following data:

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

**BALANCE SHEETS**

*December 31, 1986*

<table>
<thead>
<tr>
<th>Assets</th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$150,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>190,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$430,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Property, plant, and equipment (net)</td>
<td>365,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Investment in Sub (equity method)</td>
<td>$315,000</td>
<td>—</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,110,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

**Liabilities and Stockholders' Equity**

| Current liabilities | | |
| Accounts payable | $100,000 | $60,000 |
| Accrued liabilities | 30,000 | 20,000 |
| Total current liabilities | $130,000 | 80,000 |

| Stockholders' equity | | |
| Common stock ($10 par) | 220,000 | 30,000 |
| Additional paid-in capital | 140,000 | 100,000 |
| Retained earnings | 620,000 | 140,000 |
| Total stockholders' equity | $980,000 | 270,000 |

| Total liabilities and stockholders' equity | $1,110,000 | $350,000 |

**INCOME STATEMENTS**

*For the Year Ended December 31, 1986*

| | Par | Sub |
| Sales | $1,000,000 | $300,000 |
| Cost of goods sold | 770,000 | 200,000 |
| Gross margin | 230,000 | 100,000 |
| Other operating expenses | 130,000 | 50,000 |
| Operating income | 100,000 | 50,000 |
| Equity in earnings of Sub | 25,000 | — |
| Income before income taxes | 125,000 | 50,000 |
| Provision for income taxes | 40,000 | 20,000 |
| Net income | $85,000 | $30,000 |

**Additional information:**

- On January 1, 1986, Par purchased for $300,000 all of Sub's $10 par, voting common stock. On January 1, 1986, the fair value of Sub's assets and liabilities equaled their carrying amount of $330,000 and $80,000, respectively. Par's policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.

- During 1986, Par and Sub paid cash dividends of $50,000 and $10,000, respectively. For tax purposes, Par receives the 100% exclusion for dividends received from Sub.

- There were no intercompany transactions except for Par's receipt of dividends from Sub, and Par's recording of its share of Sub's earnings.

- On June 30, 1986, Par issued 2,000 shares of common stock for $17 per share. There were no other changes in either Par's or Sub's common stock during 1986.

- Both Par and Sub paid income taxes at the rate of 40%.

10. Par's January 1, 1986 inventory was $110,000. Par's (parent only) 1986 inventory turnover ratio was
   a. 11.1
   b. 10.0
   c. 7.7
   d. 7.0

1N86

Items 56 and 57 are based on the following data:

**Apex Corporation**

**SELECTED FINANCIAL DATA**

*Year Ended December 31, 1985*

| | | |
| Operating income | $900,000 | |
| Interest expense | 100,000 | |
| Income before income tax | 800,000 | |
| Income tax expense | 320,000 | |
| Net income | 480,000 | |
| Preferred stock dividends | 200,000 | |
| Net income available to common stockholders | | |
| Common stock dividends | $280,000 | |

| Common stock dividends | $120,000 | |

56. The times interest earned ratio is
   a. 2.8 to 1.
   b. 4.8 to 1.
   c. 8.0 to 1.
   d. 9.0 to 1.

57. The times preferred dividend earned ratio is
   a. 1.4 to 1.
   b. 1.7 to 1.
   c. 2.4 to 1.
   d. 4.0 to 1.

AP-85
Accounting Practice

1M86#59. During 1985, Dunn Company purchased $1,920,000 of inventory. The cost of goods sold for 1985 was $1,800,000 and the ending inventory at December 31, 1985, was $360,000. What was the inventory turnover for 1985?

a. 5.0
b. 5.3
c. 6.0
d. 6.4

Kay's inventory turnover for 1984 is
a. 3.57 times.
b. 3.85 times.
c. 5.36 times.
d. 5.77 times.

1M85#59. At December 31, 1983, Mason, Inc., had 100,000 shares of $10 par value common stock issued and outstanding. There was no change in the number of shares outstanding during 1984. Total stockholders' equity at December 31, 1984, was $2,800,000. The net income for the year ended December 31, 1984, was $800,000. During 1984 Mason paid $3 per share in dividends on its common stock. The quoted market value of Mason's common stock was $48 per share on December 31, 1984. What was the price-earnings ratio on common stock for 1984?

a. 9.6 to 1.
b. 8.0 to 1.
c. 6.0 to 1.
d. 3.5 to 1.

2M86
Items 4 through 6 are based on the following data pertaining to Fox Co. for the calendar year 1985:

Sales (all on credit) $2,000,000
Gross profit on sales 900,000
Net income 150,000
Purchases 1,000,000
Inventory at end of year 200,000
Accounts receivable at beginning of year 600,000
Accounts receivable at end of year 400,000

Stockholders' equity at end of year:
Common stock outstanding (uncharged during year) —
300,000 shares at par
of $1 per share $300,000
Retained earnings 500,000 800,000

Dividends paid during the year totaled $0.25 per share. The market price per share of Fox's stock was $5 at the end of the year.

4. Fox's inventory turnover for 1985 was
a. 2.0 times.
b. 2.2 times.
c. 4.4 times.
d. 5.0 times.

5. Fox's accounts receivable turnover for 1985 was
a. 1.8 times.
b. 2.0 times.
c. 4.0 times.
d. 5.0 times.

6. The price-earnings ratio on Fox's common stock at the end of the year was
a. 2.0 to 1.
b. 2.5 to 1.
c. 10.0 to 1.
d. 20.0 to 1.

1M84#6. Lyon Company's net accounts receivable were $1,000,000 at December 31, 1982, and $1,200,000 at December 31, 1983. Net cash sales for 1983 were $400,000. The accounts receivable turnover for 1983 was 5.0. Lyon's net sales for 1983 were
a. $11,000,000
b. $ 6,400,000
c. $ 6,000,000
d. $ 5,900,000

2M84#7. The following information pertains to Bass Co. for 1983:

<table>
<thead>
<tr>
<th>Merchandise purchased</th>
<th>$1,800,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Inventory at December</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>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock</td>
<td>$180,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>648,000</td>
<td>840,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>192,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Net income for year ended</td>
<td>144,000</td>
<td>240,000</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%

1N86#60. Selected information from the accounting records of Kay Company is as follows:

<table>
<thead>
<tr>
<th>December 31</th>
<th>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales for 1984</td>
<td>$1,800,000</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold for 1984</td>
<td>1,200,000</td>
<td></td>
</tr>
<tr>
<td>Inventory at 12/31/83</td>
<td>360,000</td>
<td></td>
</tr>
<tr>
<td>Inventory at 12/31/84</td>
<td>312,000</td>
<td></td>
</tr>
</tbody>
</table>
1N83#18. Selected information from the accounting records of Dalton Manufacturing Company is as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>1982</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales for 1982</td>
<td>$1,800,000</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold for 1982</td>
<td>1,200,000</td>
<td></td>
</tr>
<tr>
<td>Inventories at December 31, 1981</td>
<td>336,000</td>
<td></td>
</tr>
<tr>
<td>Inventories at December 31, 1982</td>
<td>288,000</td>
<td></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:

- Common stock, $2 par value; 100,000 shares authorized, issued, and outstanding
- 10% noncumulative, nonconvertible preferred stock, $100 par value; 1,000 shares authorized, issued, and outstanding

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

Selected Questions

2M83

Items 24 through 30 are based on the following information:

Best Corporation

<table>
<thead>
<tr>
<th>BALANCE SHEETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31,</td>
</tr>
<tr>
<td>1982</td>
</tr>
<tr>
<td>Assets</td>
</tr>
<tr>
<td>Current assets:</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Accounts receivable - net</td>
</tr>
<tr>
<td>Merchandise inventory</td>
</tr>
<tr>
<td>Total current assets</td>
</tr>
<tr>
<td>Land, buildings, and fixtures</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
</tr>
<tr>
<td>1,120,000</td>
</tr>
<tr>
<td>Total assets</td>
</tr>
<tr>
<td>Liabilities and stockholders' equity</td>
</tr>
<tr>
<td>Current liabilities:</td>
</tr>
<tr>
<td>Accounts payable</td>
</tr>
<tr>
<td>Accrued expenses</td>
</tr>
<tr>
<td>Dividends payable</td>
</tr>
<tr>
<td>Total current liabilities</td>
</tr>
<tr>
<td>Stockholders' equity:</td>
</tr>
<tr>
<td>Common stock ($10 par value)</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td>2,030,000</td>
</tr>
<tr>
<td>Total liabilities and stockholders' equity</td>
</tr>
</tbody>
</table>

Best Corporation

<table>
<thead>
<tr>
<th>INCOME STATEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year ended December 31,</td>
</tr>
<tr>
<td>1982</td>
</tr>
<tr>
<td>Credit sales</td>
</tr>
<tr>
<td>Cost of goods sold</td>
</tr>
<tr>
<td>Gross profit</td>
</tr>
<tr>
<td>Expenses (including income taxes)</td>
</tr>
<tr>
<td>Net income</td>
</tr>
</tbody>
</table>

AP-87
Accounting Practice

Best Corporation

CHANGES IN STOCKHOLDERS' EQUITY

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>1982</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<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>

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

K. Personal Financial Statements

1M87#53. Leslie Shaw's personal statement of financial condition at December 31, 1986, shows net worth of $400,000 before consideration of employee stock options owned on that date. Information relating to the stock options is as follows:

- Options to purchase 10,000 shares of Korn Corporation stock.
- Option exercise price is $10 a share.
- Market price of the stock is $25 a share on December 31, 1986.

- Assume that exercise of the options in 1987 would result in ordinary income taxable at 35%.

After giving effect to the stock options, Shaw's net worth at December 31, 1986, would be
a. $497,500  b. $550,000  c. $562,500  d. $650,000

1N86#58. Included in W. Cody's assets at December 31, 1985, are the following:

- 2,000 shares of Dart Corporation common stock purchased in 1982 for $100,000. The market value of the stock was $80 per share at December 31, 1985.

- A $500,000 whole life insurance policy having a cash value of $72,000 at December 31, 1985, subject to a $30,000 loan payable to the insurance company.

In Cody's December 31, 1985, personal statement of financial condition, the above assets should be reported at
a. $232,000  b. $202,000  c. $172,000  d. $142,000

2M86#3. Jay Dunn owns 50% of the common stock of Nolan Corp. Jay paid $10,000 for this stock in 1980. At December 31, 1985, it was ascertained that Jay's
50% stock ownership in Nolan had a current value of $90,000. Nolan’s cumulative net income and cash dividends declared for the five years ended December 31, 1985, were $150,000 and $20,000 respectively. In Jay’s personal statement of financial condition at December 31, 1985, how much should be shown as his net investment in Nolan?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$90,000</td>
</tr>
<tr>
<td>b.</td>
<td>$85,000</td>
</tr>
<tr>
<td>c.</td>
<td>$75,000</td>
</tr>
<tr>
<td>d.</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

1M85

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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$470,000</td>
</tr>
<tr>
<td>b.</td>
<td>$500,000</td>
</tr>
<tr>
<td>c.</td>
<td>$715,000</td>
</tr>
<tr>
<td>d.</td>
<td>$745,000</td>
</tr>
</tbody>
</table>

58. In the Tafts’ December 31, 1984, personal statement of financial condition, the liabilities listed above should be reported at a total amount of

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$ 58,000</td>
</tr>
<tr>
<td>b.</td>
<td>$ 72,000</td>
</tr>
<tr>
<td>c.</td>
<td>$258,000</td>
</tr>
<tr>
<td>d.</td>
<td>$272,000</td>
</tr>
</tbody>
</table>

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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$218,000</td>
</tr>
<tr>
<td>b.</td>
<td>$193,000</td>
</tr>
<tr>
<td>c.</td>
<td>$181,000</td>
</tr>
<tr>
<td>d.</td>
<td>$156,000</td>
</tr>
</tbody>
</table>

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 Carolsons’ December 31, 1983, personal statement of financial condition, the above assets should be reported at a total amount of

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$170,000</td>
</tr>
<tr>
<td>b.</td>
<td>$185,000</td>
</tr>
<tr>
<td>c.</td>
<td>$195,000</td>
</tr>
<tr>
<td>d.</td>
<td>$210,000</td>
</tr>
</tbody>
</table>

L. Combined Financial Statements

1M87#60. Selected information for two unconsolidated subsidiaries of Ray Company taken from their
Accounting Practice

pre-closing trial balances at December 31, 1986, is as follows:

<table>
<thead>
<tr>
<th>Ash Company</th>
<th>Bix Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. (Cr.)</td>
<td>Dr. (Cr.)</td>
</tr>
<tr>
<td>Inventory, 1/1/86</td>
<td>$120,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>190,000</td>
</tr>
<tr>
<td>Shipments to Bix</td>
<td>(80,000)</td>
</tr>
<tr>
<td>Shipments from Ash</td>
<td>—</td>
</tr>
<tr>
<td>Unrealized inter-company inventory profit</td>
<td>(20,000)</td>
</tr>
</tbody>
</table>

Additional data relating to the inventory at December 31, 1986, are as follows:

Inventory acquired from outside parties | $125,000 | $ 25,000 |
Bix inventory acquired from Ash | — | 30,000 |

At December 31, 1986, the inventory reported on the combined balance sheet of the two unconsolidated subsidiaries should be

a. $150,000  
b. $160,000  
c. $174,000  
d. $180,000

2M86#13. Combined financial statements are being prepared for a group of unconsolidated subsidiaries having intercompany loans of $100,000 and intercompany profits of $300,000. How much of these intercompany loans and profits should be eliminated?

<table>
<thead>
<tr>
<th>Intercompany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>a.</td>
</tr>
<tr>
<td>b.</td>
</tr>
<tr>
<td>c.</td>
</tr>
<tr>
<td>d.</td>
</tr>
</tbody>
</table>

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

2M87

Items 23 through 25 are based on the following data pertaining to Lam Co.'s manufacturing operations:

<table>
<thead>
<tr>
<th>Inventories</th>
<th>4/1/87</th>
<th>4/30/87</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$18,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Work-in-process</td>
<td>9,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>27,000</td>
<td>36,000</td>
</tr>
</tbody>
</table>

Additional information for the month of April 1987:

- Direct materials purchased: $42,000
- Direct labor payroll: $30,000
- Direct labor rate per hour: $7.50
- Factory overhead rate per direct labor hour: 10.00

23. For the month of April 1987, prime cost incurred was

a. $75,000  
b. $69,000  
c. $45,000  
d. $39,000

24. For the month of April 1987, conversion cost incurred was

a. $30,000  
b. $40,000  
c. $70,000  
d. $72,000

25. For the month of April 1987, cost of goods manufactured was

a. $118,000  
b. $115,000  
c. $112,000  
d. $109,000

2N86#29. Nil Co. uses a predetermined factory overhead application rate based on direct labor cost. For the year ended December 31, 1985, Nil's budgeted factory overhead was $600,000, based on a budgeted volume of 50,000 direct labor hours, at a standard direct labor rate of $6.00 per hour. Actual factory overhead amounted to $620,000, with actual direct labor cost of $325,000. For 1985, overapplied factory overhead was

a. $20,000  
b. $25,000  
c. $30,000  
d. $50,000

2N85#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>Maintenance</td>
</tr>
<tr>
<td>Overhead costs incurred</td>
</tr>
</tbody>
</table>

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Selected Questions

Service Departments

<table>
<thead>
<tr>
<th>Maintenance</th>
<th>Utilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Service provided to departments:</strong></td>
<td></td>
</tr>
<tr>
<td>Maintenance</td>
<td>10%</td>
</tr>
<tr>
<td>Utilities</td>
<td>20%</td>
</tr>
<tr>
<td>Producing — A</td>
<td>40%</td>
</tr>
<tr>
<td>Producing — B</td>
<td>40%</td>
</tr>
<tr>
<td>Totals</td>
<td>100%</td>
</tr>
</tbody>
</table>

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 application rate. 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

2N85 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:

**Wages**
- Machine operators: $200,000
- Maintenance workers: 30,000
- Factory foremen: 90,000

**Materials used**
- Metal wire: $500,000
- Lubricant for oiling machinery: 10,000
- Plastic coating: 380,000

2. Blum’s 1984 direct labor amounted to
- a. $220,000
- 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

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

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 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>

AP-91
Accounting Practice

**Month of January 1983**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods manufactured</td>
<td>$515,000</td>
</tr>
<tr>
<td>Factory overhead applied</td>
<td>150,000</td>
</tr>
<tr>
<td>Direct materials used</td>
<td>190,000</td>
</tr>
<tr>
<td>Actual factory overhead</td>
<td>144,000</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>Description</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>Description</th>
<th>Amount</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

**B. Process and Job Order Costing**

2M87#40. Bart Co. adds materials at the beginning of the process in Department M. The following information pertains to Department M's work-in-process during April:

<table>
<thead>
<tr>
<th>Unit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process, April 1</td>
<td>3,000</td>
</tr>
<tr>
<td>(60% complete as to conversion cost)</td>
<td></td>
</tr>
<tr>
<td>Started in April</td>
<td>25,000</td>
</tr>
<tr>
<td>Completed</td>
<td>20,000</td>
</tr>
<tr>
<td>Work-in-process, April 30</td>
<td>8,000</td>
</tr>
<tr>
<td>(75% complete as to conversion cost)</td>
<td></td>
</tr>
</tbody>
</table>

Under the weighted average method, the equivalent units for conversion cost are
   a. 26,000
   b. 25,000
   c. 24,200
   d. 21,800

2N86#27. The following information pertains to Top Co.'s Division D for the month of May:

<table>
<thead>
<tr>
<th>Number of units</th>
<th>Cost of materials</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning work-in-process</td>
<td>30,000</td>
</tr>
<tr>
<td>Started in May</td>
<td>80,000</td>
</tr>
<tr>
<td>Units completed</td>
<td>85,000</td>
</tr>
<tr>
<td>Ending work-in-process</td>
<td>25,000</td>
</tr>
</tbody>
</table>

All materials are added at the beginning of the process. Using the weighted-average method, the cost per equivalent unit for materials is
   a. $0.43
   b. $0.45
   c. $0.55
   d. $0.59

2N86#38. Marc Corp. has a job order cost system. The following debits (credits) appeared in the work-in-process account for the month of May 1986:

<table>
<thead>
<tr>
<th>May</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Balance</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>31</td>
<td>Direct materials</td>
<td>60,000</td>
</tr>
<tr>
<td>31</td>
<td>Direct labor</td>
<td>40,000</td>
</tr>
<tr>
<td>31</td>
<td>Factory overhead</td>
<td>32,000</td>
</tr>
<tr>
<td>31</td>
<td>To finished goods</td>
<td>(120,000)</td>
</tr>
</tbody>
</table>

Marc applies overhead to production at a predetermined rate of 80% based on direct labor cost. Job No.

AP-92
23, the only job still in process at the end of May 1986, has been charged with direct labor of $5,000. The amount of direct materials charged to Job No. 23 was

a. $6,250
b. $7,500
c. $13,000
d. $17,000

2M86#22. Lucas Co. has a job order cost system. For the month of April 1986, the following debits (credits) appeared in the general ledger account, work-in-process:

<table>
<thead>
<tr>
<th>April</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Balance</td>
</tr>
<tr>
<td>30</td>
<td>Direct materials</td>
</tr>
<tr>
<td>30</td>
<td>Direct labor</td>
</tr>
<tr>
<td>30</td>
<td>Factory overhead</td>
</tr>
<tr>
<td>30</td>
<td>To finished goods</td>
</tr>
</tbody>
</table>

Balance, April 1 $24,000
Direct materials 80,000
Direct labor 60,000
Factory overhead 54,000
To finished goods (200,000)

Lucas applies overhead to production at a predetermined rate of 90% based on direct labor cost. Job No. 100, the only job still in process at the end of April, has been charged with factory overhead of $4,500. The amount of direct materials charged to Job No. 100 was

a. $18,000
b. $8,500
c. $5,000
d. $4,500

2M86#25. Kew Co. had 3,000 units in work-in-process at April 1, 1986, which were 60% complete as to conversion cost. During April, 10,000 units were completed. At April 30, 4,000 units remained in work-in-process which were 40% complete as to conversion cost. Direct materials are added at the beginning of the process. How many units were started during April?

a. 9,000
b. 9,800
c. 10,000
d. 11,000

2M86#26. For the month of April, Thorp Co.'s records disclosed the following data relating to direct labor:

<table>
<thead>
<tr>
<th></th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual cost</td>
<td></td>
</tr>
<tr>
<td>Rate variance</td>
<td>1,000 favorable</td>
</tr>
<tr>
<td>Efficiency variance</td>
<td>1,500 unfavorable</td>
</tr>
<tr>
<td>Standard cost</td>
<td>$9,500</td>
</tr>
</tbody>
</table>

For the month of April, actual direct labor hours amounted to 2,000. In April, Thorp's standard direct labor rate per hour was

a. $5.50
b. $5.00
c. $4.75
d. $4.50

2M85#12. During March 1985 Bly Co.'s Department Y equivalent unit product costs, computed under the weighted-average method, were as follows:

- Materials $1
- Conversion 3
- Transferred-in 5

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

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></th>
<th>$24,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, April 1</td>
<td></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 (200,000)</td>
<td></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

1M83#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>

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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

1M83#45. 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>
</table>
| Work-in-process, 1/1/83 (40% complete as to conversion costs) | 500
| Started in January | 2,000
| Transferred to department Two during January | 2,100
| Work-in-process, 1/31/83 (25% complete as to conversion costs) | 400

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:

| Direct materials | $4,200 |
| Direct-labor hours worked | 300 |
| Direct-labor rate per hour | $8.00 |
| Machine hours used | 200 |
| Applied factory overhead rate per machine hour | $15.00 |

What is the total manufacturing cost recorded on Job 1501 for February 1983?

a. $ 8,800
b. $ 9,600
c. $10,300
d. $11,100

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>Direct materials</th>
<th>$25,000</th>
<th>$ 5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct labor</td>
<td>?</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>40,000</td>
<td>?</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

C. Standard Costing

2M87

Items 32 and 33 are based on the following data:

The following processing standards have been set for Duo Co.'s clerical workers:

| Number of hours per 1,000 papers processed | 150 |
| Normal number of papers processed per year | 1,500,000 |
| Wage rate per 1,000 papers | $600 |
| Standard variable cost of processing 1,500,000 papers | $900,000 |
| Fixed costs per year | $150,000 |

The following information pertains to the 1,200,000 papers that were processed during 1986:

| Total cost | $915,000 |
| Labor cost | $760,000 |
| Labor hours | 190,000 |

32. For 1986, Duo's expected total cost to process the 1,200,000 papers, assuming standard performance, should be
a. $910,000
b. $900,000
c. $870,000
d. $840,000

AP-94
Selected Questions

2M86

Items 23 and 24 are based on the following data:

Based on a monthly normal volume of 50,000 units (100,000 direct labor hours), Raff Co.'s standard cost system contains the following overhead costs:

<table>
<thead>
<tr>
<th>Variable</th>
<th>$6 per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed</td>
<td>$8 per unit</td>
</tr>
</tbody>
</table>

The following information pertains to the month of March 1986:

Units actually produced 38,000
Actual direct labor hours worked 80,000

Actual overhead incurred:

<table>
<thead>
<tr>
<th>Variable</th>
<th>$250,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed</td>
<td>384,000</td>
</tr>
</tbody>
</table>

23. For March 1986 the unfavorable variable overhead spending variance was
   a. $6,000
   b. $10,000
   c. $12,000
   d. $22,000

24. For March 1986 the fixed overhead volume variance was
   a. $96,000 unfavorable.
   b. $96,000 favorable.
   c. $80,000 unfavorable.
   d. $80,000 favorable.

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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard quantity of</td>
<td>5 lbs.</td>
</tr>
<tr>
<td>Standard cost per lb.</td>
<td>$.20</td>
</tr>
<tr>
<td>Standard direct labor hours</td>
<td>.4</td>
</tr>
<tr>
<td>Standard wage rate per hour</td>
<td>$7.00</td>
</tr>
<tr>
<td>Materials purchased</td>
<td>100,000 lbs.</td>
</tr>
<tr>
<td>Cost of materials purchased</td>
<td>$.17 per lb.</td>
</tr>
<tr>
<td>Materials consumed for manufacture of 10,000 units</td>
<td>60,000 lbs.</td>
</tr>
<tr>
<td>Actual direct labor hours required for 10,000 units</td>
<td>3,900</td>
</tr>
<tr>
<td>Actual direct labor cost per hour</td>
<td>$7.20</td>
</tr>
</tbody>
</table>

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 finished product requires 2 direct-labor hours. The following data are available for the April 1983 production activity:

<table>
<thead>
<tr>
<th>Equivalent units of product</th>
<th>9,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct-labor hours worked</td>
<td>19,500</td>
</tr>
<tr>
<td>Actual total overhead incurred</td>
<td>$79,500</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Actual quantity purchased</th>
<th>18,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual unit purchase price</td>
<td>$3.60</td>
</tr>
<tr>
<td>Materials purchase price variance—unfavorable (based on purchases)</td>
<td>$3,600</td>
</tr>
<tr>
<td>Standard quantity allowed for actual production</td>
<td>16,000</td>
</tr>
<tr>
<td>Actual quantity used</td>
<td>15,000</td>
</tr>
</tbody>
</table>

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

AP-95
1M83#39. Universal Company uses a standard cost system and prepared the following budget at normal capacity for the month of January 1983:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>24,000</td>
<td>$48,000</td>
</tr>
<tr>
<td>Direct-labor</td>
<td></td>
<td>$108,000</td>
</tr>
<tr>
<td>hours</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable factory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>overhead</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed factory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>overhead</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total factory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>overhead per</td>
<td></td>
<td></td>
</tr>
<tr>
<td>direct-labor</td>
<td></td>
<td>$6.50</td>
</tr>
<tr>
<td>hour</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Actual data for January 1983 were as follows:

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct-labor hours</td>
<td>22,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>worked</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total factory overhead</td>
<td></td>
<td>$147,000</td>
<td></td>
</tr>
<tr>
<td>Standard direct-labor</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>hours allowed for</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>capacity attained</td>
<td></td>
<td>21,000</td>
<td></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.

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

2M87#31. Axe Co. produces joint products J and K from a process that yields byproduct B. The cost assigned to byproduct B is its market value less additional costs incurred after splitoff. Information concerning a batch produced in April at a joint cost of $60,000 is as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>Units produced</th>
<th>Additional costs</th>
<th>Market values</th>
</tr>
</thead>
<tbody>
<tr>
<td>J</td>
<td>1,000</td>
<td>$15,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>K</td>
<td>2,000</td>
<td>10,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>B</td>
<td>4,000</td>
<td>2,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

How much of the joint cost should be allocated to the joint products?

a. $53,000
b. $55,000
c. $57,000
d. $58,000

2N86#37. Dex Co. had the following production for the month of June:

<table>
<thead>
<tr>
<th></th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process</td>
<td></td>
</tr>
<tr>
<td>at June 1</td>
<td>10,000</td>
</tr>
<tr>
<td>Started during</td>
<td>40,000</td>
</tr>
<tr>
<td>June</td>
<td></td>
</tr>
<tr>
<td>Completed and</td>
<td></td>
</tr>
<tr>
<td>transferred</td>
<td></td>
</tr>
<tr>
<td>to finished</td>
<td>33,000</td>
</tr>
<tr>
<td>goods</td>
<td></td>
</tr>
<tr>
<td>Abnormal</td>
<td>2,000</td>
</tr>
<tr>
<td>spoilage incurred</td>
<td></td>
</tr>
<tr>
<td>Work-in-process</td>
<td>15,000</td>
</tr>
<tr>
<td>at June 30</td>
<td></td>
</tr>
</tbody>
</table>

Materials are added at the beginning of the process. As to conversion cost, the beginning work-in-process was 70% completed and the ending work-in-process was 60% completed. Spoilage is detected at the end of the process. Using the weighted-average method, the equivalent units for June, with respect to conversion cost, were

a. 42,000
b. 44,000
c. 45,000
d. 46,000

2N86#39. Lite Co. manufactures products X and Y from a joint process that also yields a by-product, Z. Revenue from sales of Z is treated as a reduction of joint costs. Additional information is as follows:

<table>
<thead>
<tr>
<th>Products</th>
<th>X</th>
<th>Y</th>
<th>Z</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units</td>
<td>20,000</td>
<td>20,000</td>
<td>10,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Joint costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales value at splitoff</td>
<td>$300,000</td>
<td>$150,000</td>
<td>$10,000</td>
<td>$460,000</td>
</tr>
</tbody>
</table>

Joint costs were allocated using the sales value at splitoff approach. The joint costs allocated to product X were

a. $75,000
b. $100,800
c. $150,000
d. $168,000

2M86#21. In manufacturing its products for the month of March 1986, Kane Co. incurred normal spoilage of $10,000 and abnormal spoilage of $12,000. How much
Selected Questions

spoilage cost should Kane charge as a period cost for
the month of March 1986?
a. $22,000
b. $12,000
c. $10,000
d. $0

2N86#36. Abel Corp. manufactures a product that
yields the by-product, “Yum.” The only costs associated
with Yum are selling costs of $.10 for each unit
sold. Abel accounts for sales of Yum by deducting
Yum’s separable costs from Yum’s sales, and then de-
ducting this net amount from the major product’s cost
of goods sold. Yum’s sales were 100,000 units at $1
each. If Abel changes its method of accounting for
Yum’s sales by showing the net amount as additional
sales revenue, then Abel’s gross margin would
a. Increase by $ 90,000.
b. Increase by $100,000.
c. Increase by $110,000.
d. Be unaffected.

2N86#39. Lowe Co. manufactures products A and B
from a joint process. Sales value at split-off was
$700,000 for 10,000 units of A, and $300,000 for 15,000
units of B. Using the sales value at split-off approach,
joint costs properly allocated to A were $140,000. Total
joint costs were
a. $ 98,000
b. $200,000
c. $233,333
d. $350,000

2N85#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 be-
yond 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

2N85#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 at-
tributed $30,000 to normal spoilage and $20,000 to ab-
normal 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.

2N85#8. Lane Co. produces main products Kul and
Wu. The process also yields by-product Zef. Net re-
alizable value of by-product Zef is subtracted from joint
production cost of Kul and Wu. The following infor-
mation 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 allo-
ating 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

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 pro-
cessed 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 pro-
duced 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

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:
- Direct materials: $660
- Direct labor: 800
- Factory overhead (150% of direct labor): 1,200

Total: $2,660

Direct costs of reworking 10 units:
- Direct materials: $100
- Direct labor: 160

Total: $260

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>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process at March 1</td>
</tr>
<tr>
<td>Started during March</td>
</tr>
<tr>
<td>Completed and transferred to next department during March</td>
</tr>
<tr>
<td>Normal spoilage incurred</td>
</tr>
<tr>
<td>Work-in-process at March 31</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>
</tbody>
</table>

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:

Direct materials: $10
Direct labor: 8
Applied factory overhead: 12

Total: $30

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

1M83#38. 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>
Selected Questions

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

E. Absorption and Variable Costing

2M87 #29. During May, Roy Co. produced 10,000 units of Product X. Costs incurred by Roy during May were as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$10,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>20,000</td>
</tr>
<tr>
<td>Variable manufacturing overhead</td>
<td>5,000</td>
</tr>
<tr>
<td>Variable selling and general</td>
<td>3,000</td>
</tr>
<tr>
<td>Fixed manufacturing overhead</td>
<td>9,000</td>
</tr>
<tr>
<td>Fixed selling and general</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$51,000</td>
</tr>
</tbody>
</table>

Under absorption costing, Product X's unit cost was

- a. $5.10
- b. $4.40
- c. $3.80
- d. $3.50

2M86 #26. Luna Co.'s 1985 manufacturing costs were as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials and direct labor</td>
<td>$500,000</td>
</tr>
<tr>
<td>Depreciation of manufacturing equipment</td>
<td>70,000</td>
</tr>
<tr>
<td>Depreciation of factory building</td>
<td>40,000</td>
</tr>
<tr>
<td>Janitor's wages for cleaning</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$655,000</td>
</tr>
</tbody>
</table>

How much of these costs should be inventoried for external reporting purposes?

- a. $625,000
- b. $610,000
- c. $585,000
- d. $500,000

2M84

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>Item</th>
<th>Cost</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><strong>Total</strong></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>Item</th>
<th>Cost</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>Item</th>
<th>Cost</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>—</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>$120,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>70,000</td>
</tr>
</tbody>
</table>

AP-99
Accounting Practice

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

F. Budgeting and Flexible Budgeting

2N87#39. Glo Co., a manufacturer of combs, budgeted sales of 125,000 units for the month of April 1987. The following additional information is provided:

<table>
<thead>
<tr>
<th>Number of units</th>
<th>3/1/83</th>
<th>3/31/83</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual inventory at April 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Work-in-process</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Finished goods</td>
<td>37,500</td>
<td></td>
</tr>
<tr>
<td>Budgeted inventory at April 30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Work-in-process (75% processed)</td>
<td>8,000</td>
<td></td>
</tr>
<tr>
<td>Finished goods</td>
<td>30,000</td>
<td></td>
</tr>
</tbody>
</table>

How many equivalent units of production did Glo budget for April 1987?
   a. 126,500
   b. 125,500
   c. 123,500
   d. 117,500

2N86

Items 22 through 26 are based on the following data:

Oslo Co.’s industrial photo-finishing division, Rho, incurred the following costs and expenses in 1985:

<table>
<thead>
<tr>
<th>Variable</th>
<th>Fixed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$200,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>$150,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>$70,000</td>
</tr>
<tr>
<td>General, selling, and administrative</td>
<td>$30,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$450,000</td>
</tr>
</tbody>
</table>

During 1985, Rho produced 300,000 units of industrial photo-prints, which were sold for $2.00 each. Oslo’s investment in Rho was $500,000 and $700,000 at January 1, 1985, and December 31, 1985, respectively. Oslo normally imputes interest on investments at 15% of average invested capital.

26. Based on Rho’s 1985 financial data, and an estimated 1986 production of 350,000 units of industrial photo-prints, Rho’s estimated 1986 total costs and expenses would be
   a. $525,000
   b. $540,000
   c. $615,000
   d. $630,000

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 | 110,000 pounds |
| Product Y      | 22,000 units   | 24,000 units   |

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?
   a. 126,000
   b. 132,000
   c. 136,000
   d. 142,000

1N83#55. In preparing its cash budget for July 1983, Reed Company made the following projections:

Sales $1,500,000
Gross profit (based on sales) 25%
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>
Selected Questions

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.

G. Breakeven and Cost-Volume-Profit Analysis

2M87

Items 34 through 38 are based on the following selected data pertaining to Mar Co.'s Alo Division for 1986:

Sales $100,000
Variable costs 60,000
Traceable fixed costs 10,000
Average invested capital 20,000
Imputed interest rate on average invested capital 12%

In addition, consideration is being given to the possible purchase of a $30,000 machine for Alo, which is expected to result in a decrease of $12,000 per year in cash operating expenses. This machine, which has no residual value, has an estimated useful life of five years and will be depreciated on a straight-line basis.

34. Before the purchase of the $30,000 machine, Alo's breakeven point in sales dollars was

a. $16,667
b. $25,000
c. $30,000
d. $70,000

2M86

Items 22 through 26 are based on the following data:

Oslo Co.'s industrial photo-finishing division, Rho, incurred the following costs and expenses in 1985:

<table>
<thead>
<tr>
<th></th>
<th>Variable</th>
<th>Fixed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$200,000</td>
<td></td>
</tr>
<tr>
<td>Direct labor</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>70,000</td>
<td>$42,000</td>
</tr>
<tr>
<td>General, selling, and administrative</td>
<td>30,000</td>
<td>48,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$450,000</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

During 1985, Rho produced 300,000 units of industrial photo-prints, which were sold for $2.00 each. Oslo's investment in Rho was $500,000 and $700,000 at January 1, 1985, and December 31, 1985, respectively. Oslo normally imputes interest on investments at 15% of average invested capital.

24. How many industrial photo-print units did Rho have to sell in 1985 to break even?

a. 180,000
b. 120,000
c. 90,000
d. 60,000

2M86#34. Kent Co.'s 1985 operating percentages were as follows:

Sales 100%
Cost of sales Variable 50%
Fixed 10 60
Gross profit 40
Other operating expenses Variable 20
Fixed 15 35
Operating income 5%

Kent's 1985 sales totaled $2,000,000. At what 1985 sales level would Kent break even?

a. $1,900,000
b. $1,666,667
c. $1,250,000
d. $ 833,333

2M86#27. The following information pertains to Nova Co.'s cost-volume-profit relationships:

Breakeven point in units sold 1,000
Variable costs per unit $ 500
Total fixed costs $150,000

How much will be contributed to profit before income taxes by the 1,001st unit sold?

a. $650
b. $500
c. $150
d. $0

2M86

Items 29 and 30 are based on the following data pertaining to two types of products manufactured by Korn Corp.:

<table>
<thead>
<tr>
<th></th>
<th>Sales</th>
<th>Variable costs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>price</td>
<td>costs</td>
</tr>
<tr>
<td>Product Y</td>
<td>$120</td>
<td>$ 70</td>
</tr>
<tr>
<td>Product Z</td>
<td>500</td>
<td>200</td>
</tr>
</tbody>
</table>

Fixed costs total $300,000 annually. The expected mix in units is 60% for product Y and 40% for product Z.

29. How much is Korn's breakeven sales in units?

a. 857
b. 1,111
c. 2,000
d. 2,459
30. How much is Korn's breakeven sales in dollars?
   a. $300,000
   b. $420,000
   c. $475,000
   d. $544,000

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

2N84

Items 14 and 15 are based on the following data:

   The following information pertains to Rica Company:

   | Sales (50,000 units) | $1,000,000 |
   | Direct materials and direct labor | 300,000 |
   | Factory overhead: |
   | Variable | 40,000 |
   | Fixed | 70,000 |
   | Selling and general expenses: |
   | Variable | 10,000 |
   | Fixed | 60,000 |

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%

2M87

Items 34 through 38 are based on the following selected data pertaining to Mar Co.'s Alo Division for 1986:

   | Sales | $100,000 |
   | Variable costs | 60,000 |
   | Traceable fixed costs | 10,000 |
   | Average invested capital | 20,000 |
   | Imputed interest rate on average invested capital | 12%

In addition, consideration is being given to the possible purchase of a $30,000 machine for Alo, which is expected to result in a decrease of $12,000 per year in cash operating expenses. This machine, which has no residual value, has an estimated useful life of five years and will be depreciated on a straight-line basis.

37. For the new machine, the accounting rate of return based on initial investment would be
   a. 12%
   b. 20%
   c. 30%
   d. 40%

38. If income taxes are ignored, the payback period for the new machine would be
   a. 1.67 years.
   b. 2.50 years.
   c. 4.17 years.
   d. 5.00 years.

2N86

Items 31 through 33 are based on the following data:

   Allo Foundation, a tax-exempt organization, invested $200,000 in a five-year project at the beginning of 1985. Allo estimates that the annual cash savings from this project will amount to $65,000. The $200,000 of assets will be depreciated over their five-year life on the straight-line basis. On investments of this type, Allo's desired rate of return is 12%. Information on present value factors is as follows:

   | Present value of 1 for 5 periods | At 12% | At 14% | At 16% |
   | Present value of an annuity of 1 for 5 periods | 3.6 | 3.4 | 3.3 |
31. The net present value of the project is
   a. $ 34,000
   b. $ 36,400
   c. $ 90,000
   d. $125,000

32. Allo's internal rate of return on this project is
   a. Less than 12%.
   b. Less than 14%, but more than 12%.
   c. Less than 16%, but more than 14%.
   d. More than 16%.

33. For the project's first year, Allo's accounting rate of return, based on the project's average book value for 1985, would be
   a. 14.4%
   b. 13.9%
   c. 12.5%
   d. 12.0%

2N85
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>.91</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

2N85#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

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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

1. Performance Analysis

2M87

Items 34 through 38 are based on the following selected data pertaining to Mar Co.'s Alo Division for 1986:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable costs</td>
<td>60,000</td>
</tr>
<tr>
<td>Traceable fixed costs</td>
<td>10,000</td>
</tr>
<tr>
<td>Average invested capital</td>
<td>20,000</td>
</tr>
<tr>
<td>Imputed interest rate</td>
<td></td>
</tr>
<tr>
<td>on average invested capital</td>
<td>12%</td>
</tr>
</tbody>
</table>

In addition, consideration is being given to the possible purchase of a $30,000 machine for Alo, which is expected to result in a decrease of $12,000 per year in cash operating expenses. This machine, which has no residual value, has an estimated useful life of five years and will be depreciated on a straight-line basis.

35. Before the purchase of the $30,000 machine, Alo's return on investment was
   a. 60%
   b. 75%
   c. 138%
   d. 150%

36. Before the purchase of the $30,000 machine, Alo's residual income was
   a. $27,600
   b. $30,000
   c. $32,400
   d. $40,000

2M86

Items 22 through 26 are based on the following data:

Oslo Co.'s industrial photo-finishing division, Rho, incurred the following costs and expenses in 1985:

<table>
<thead>
<tr>
<th>Variable</th>
<th>Fixed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$200,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>150,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>70,000</td>
</tr>
<tr>
<td>General, selling, and administrative</td>
<td>30,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$450,000</td>
</tr>
<tr>
<td></td>
<td>48,000</td>
</tr>
<tr>
<td></td>
<td>90,000</td>
</tr>
</tbody>
</table>

During 1985, Rho produced 300,000 units of industrial photo-prints, which were sold for $2.00 each. Oslo's investment in Rho was $500,000 and $700,000 at January 1, 1985, and December 31, 1985, respectively. Oslo normally imputes interest on investments at 15% of average invested capital.

22. For the year ended December 31, 1985, Rho's return on average investment was
   a. 15.0%
   b. 10.0%
   c. 8.6%
   d. (5.0%)

23. For the year ended December 31, 1985, Rho's residual income (loss) was
   a. $150,000
   b. $ 60,000
   c. ($ 45,000)
   d. ($ 30,000)

25. For the year ended December 31, 1985, Rho's contribution margin was
   a. $250,000
   b. $180,000
   c. $150,000
   d. $ 60,000

2M86

Items 37 and 38 are based on the following data:

The following selected data pertain to the Maple Division of Beyer Corp. for 1985:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average invested capital</td>
<td>100,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>20,000</td>
</tr>
<tr>
<td>Capital turnover</td>
<td>3.0</td>
</tr>
<tr>
<td>Imputed interest rate</td>
<td>12%</td>
</tr>
</tbody>
</table>

37. The return on investment was
   a. 6.67%
   b. 8.00%
   c. 20.00%
   d. 33.33%

38. The residual income was
   a. $2,400
   b. $5,600
   c. $6,667
   d. $8,000

2M85

Items 18 and 19 are based on the following data:

The following selected data pertain to Beck Co.'s Beam Division for 1984:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable costs</td>
<td>600,000</td>
</tr>
<tr>
<td>Traceable fixed costs</td>
<td>100,000</td>
</tr>
<tr>
<td>Average invested capital</td>
<td>200,000</td>
</tr>
<tr>
<td>Imputed interest rate</td>
<td>15%</td>
</tr>
</tbody>
</table>
Selected Questions

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%

**2M83**

Items 13 and 14 are based on the following data:

The following selected data pertain to the belt division of Allen Corp. for 1982:

- Sales: $2,000,000
- Average invested capital: 500,000
- Operating income: 300,000
- Capital turnover: 4.0
- Imputed interest rate: 18%

13. How much is the return on investment?
   a. 60%
   b. 33%
   c. 18%
   d. 15%

14. How much is the residual income?
   a. $0
   b. $200,000
   c. $210,000
   d. $246,000

**J. Other**

**2M87#21.** Joe Neil, CPA, has among his clientele a charitable organization that has a legal permit to conduct games of chance for fund-raising purposes. Neil's client derives its profit from admission fees and the sale of refreshments, and therefore wants to “break even” on the games of chance. In one of these games, the player draws one card from a standard deck of 52 cards.

A player drawing any one of four “queens” wins $5, and a player drawing any one of 13 “hearts” wins $2.

Neil is asked to compute the price that should be charged per draw, so that the total amount paid out for winning draws can be expected to equal the total amount received from all draws. Which one of the following equations should Neil use to compute the price (P)?

   a. \(5 - 2 = \frac{35P}{52}\)
   b. \(\frac{4}{52}(5) + \frac{13}{52}(2) = \frac{35P}{52}\)
   c. \(\frac{4}{52}(5 - P) + \frac{13}{52}(2 - P) = P\)
   d. \(\frac{4}{52}(5) + \frac{13}{52}(2) = P\)

**2M87#22.** Rail Co. sells 20,000 radios evenly throughout the year. The cost of carrying one unit in inventory for one year is $8, and the purchase order cost per order is $32. What is the economic order quantity?
   a. 625
   b. 400
   c. 283
   d. 200

**2M87#26.** The following standard costs pertain to a component part manufactured by Bor Co.:

- Direct materials: $4
- Direct labor: 10
- Factory overhead: 40
- Standard cost per unit: 54

Factory overhead is applied at $1 per standard machine hour. Fixed capacity cost is 60% of applied factory overhead, and is not affected by any “make or buy” decision. It would cost $49 per unit to buy the part from an outside supplier. In the decision to “make or buy,” what is the total relevant unit manufacturing cost?
   a. $54
   b. $38
   c. $30
   d. $5

**2M87#27.** Meg Co. has developed a regression equation to analyze the behavior of its maintenance costs (Q) as a function of machine hours (Z). The following equation was developed by using 30 monthly observations with a related coefficient of determination of .90:

   \[Q = 6,000 + 5.25Z\]

If 1,000 machine hours are worked in one month, the related point estimate of total maintenance costs would be
   a. $11,250
   b. $10,125
   c. $5,250
   d. $4,725

**2M87#28.** Aba Caterers quotes a price of $30 per person for a dinner party. This price includes the 6% sales tax and the 15% service charge. Sales tax is computed on the food plus the service charge. The service charge is computed on the food only. At what amount does Aba price the food?
   a. $23.70
   b. $24.61
   c. $25.50
   d. $28.20
The following data appeared in the accounting records of a retail store for the year ended December 31, 1986:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$150,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>70,000</td>
</tr>
<tr>
<td>Inventories:</td>
<td></td>
</tr>
<tr>
<td>January 1</td>
<td>35,000</td>
</tr>
<tr>
<td>December 31</td>
<td>50,000</td>
</tr>
<tr>
<td>Sales commissions</td>
<td>5,000</td>
</tr>
</tbody>
</table>

How much was the gross margin?
- a. $65,000
- b. $75,000
- c. $90,000
- d. $95,000

Items 32 and 33 are based on the following data:

The following processing standards have been set for Duo Co.'s clerical workers:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of hours per 1,000 papers processed</td>
<td>150</td>
</tr>
<tr>
<td>Normal number of papers processed per year</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Wage rate per 1,000 papers</td>
<td>$600</td>
</tr>
<tr>
<td>Standard variable cost of processing 1,500,000 papers</td>
<td>$900,000</td>
</tr>
<tr>
<td>Fixed costs: per year</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

The following information pertains to the 1,200,000 papers that were processed during 1986:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total cost</td>
<td>$915,000</td>
</tr>
<tr>
<td>Labor cost</td>
<td>$760,000</td>
</tr>
<tr>
<td>Labor hours</td>
<td>190,000</td>
</tr>
</tbody>
</table>

For 1986, Duo's labor rate variance would be
- a. $40,000 unfavorable.
- b. $32,000 favorable.
- c. $10,000 unfavorable.
- d. $0.

Tub Co. uses a standard cost system. The following information pertains to direct labor for product B for the month of October:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual rate paid</td>
<td>$8.40 per hour</td>
</tr>
<tr>
<td>Standard rate</td>
<td>$8.00 per hour</td>
</tr>
<tr>
<td>Standard hours allowed for actual production</td>
<td>2,000 hours</td>
</tr>
<tr>
<td>Labor efficiency variance</td>
<td>$1,600 unfavorable</td>
</tr>
</tbody>
</table>

What were the actual hours worked?
- a. 1,800
- b. 1,810
- c. 2,190
- d. 2,200

Lin Co. sells its merchandise at a gross profit of 30%. The following figures are among those pertaining to Lin's operations for the six months ended June 30, 1986:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$200,000</td>
</tr>
<tr>
<td>Beginning inventory</td>
<td>50,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>130,000</td>
</tr>
</tbody>
</table>

On June 30, 1986, all of Lin's inventory was destroyed by fire. The estimated cost of this destroyed inventory was

- a. $120,000
- b. $70,000
- c. $40,000
- d. $20,000

Clay Co. operates three shipping terminals, referred to as X, Y, and Z. Of the total cargo shipped, terminals X, Y, and Z handle approximately 60%, 30%, and 10%, respectively, with error rates of 3%, 4%, and 6%, respectively. Clay's internal auditor randomly selects one shipping document, ascertaining that this document contains an error. The probability that the error occurred in terminal X is

- a. 60%
- b. 50%
- c. 23%
- d. 3%

During 1985, Seco Corp. experienced the following power outages:

<table>
<thead>
<tr>
<th>Number of outages per month</th>
<th>Number of months</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

Each power outage results in out-of-pocket costs of $200. For $250 per month, Seco can lease an auxiliary generator to provide power during outages. If Seco leases an auxiliary generator in 1986, the estimated savings (or additional expenditures) for 1986 would be

- a. $800
- b. $950
- c. ($600)
- d. ($1,800)

Doe Co. wants to sell a product at a gross margin of 20%. The cost of the product is $2.00. The selling price should be

- a. $1.60
- b. $2.10
- c. $2.40
- d. $2.50

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Selected Questions

2M85#31. Adly Corp. wishes to earn a 30% return on its $100,000 investment in equipment used to produce product X. Based on estimated sales of 10,000 units of product X next year, the costs per unit would be as follows:

Variable manufacturing costs  $5
Fixed selling and administrative costs  2
Fixed manufacturing costs  

At how much per unit should product X be priced for sale?

a. $5
b. $8
c. $10
d. $11

2M85#32. Nada Co.'s pricing structure has been established to yield a gross margin of 30%. The following data pertain to the year ended December 31, 1985:

Sales  $1,000,000
Inventory, January 1, 1985  500,000
Purchases  400,000
Inventory, per actual count at December 31, 1985  80,000

Nada is satisfied that all sales and purchases have been fully and properly recorded. How much might Nada reasonably estimate as a shortage in inventory at December 31, 1985?

a. $100,000
c. $200,000
d. $276,000

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.

2M85#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
c. $170
d. $280

2M85#11. The following information pertains to material X which is used by Sage Co.:

Annual usage in units  20,000
Working days per year  250
Safety stock in units  800
Normal lead time in working days  30

Units of material X will be required evenly throughout the year. The order point is

a. 800
c. 2,400
d. 3,200

2M85#14. At December 31, 1984, Zar Co. had a machine with an original cost of $84,000, accumulated depreciation of $60,000, and an estimated salvage value of zero. On December 31, 1984, Zar was considering the purchase of a new machine having a five-year life, costing $120,000, and having an estimated salvage value of $20,000 at the end of five years. In its decision concerning the possible purchase of the new machine, how much should Zar consider as sunk cost at December 31, 1984?

a. $120,000
c. $24,000
d. $4,000

2M85#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.

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):

\[ Y = 12,000 + 10.50 X \]

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#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.

1N83#60. Gandy Company is considering a proposal to introduce a new product, RLX. An outside marketing consultant prepared the following payoff probability distribution describing the relative likelihood of monthly sales volume levels and related income (loss) for RLX:

<table>
<thead>
<tr>
<th>Monthly sales volume</th>
<th>Probability</th>
<th>Income (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>6,000</td>
<td>0.10</td>
<td>$(70,000)</td>
</tr>
<tr>
<td>12,000</td>
<td>0.20</td>
<td>10,000</td>
</tr>
<tr>
<td>18,000</td>
<td>0.40</td>
<td>60,000</td>
</tr>
<tr>
<td>24,000</td>
<td>0.20</td>
<td>100,000</td>
</tr>
<tr>
<td>30,000</td>
<td>0.10</td>
<td>140,000</td>
</tr>
</tbody>
</table>

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

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Selected Questions

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 supplies. 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?
   a. Memorandum entry only
   b. Encumbrances control
      Fund balance reserved for encumbrances
      $1,000

     Debit  Credit
     -------  -------
     $1,000   $1,000

60. What journal entry or entries should Albee make on May 2, 1984, upon receipt of the supplies and approval of the invoice?

   a. Appropriations control
      Encumbrances control
      Supplies
      Vouchers payable
      $1,000
   b. Supplies
      Vouchers payable
      $1,000
   c. Fund balance reserved for encumbrances
      Encumbrances control
      Expenditures control
      Vouchers payable
      $1,000
   d. Encumbrances control
      Appropriations control
      Fund balance
      Vouchers payable
      $1,000

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?
   a. $0
   b. $ 40,000
   c. $700,000
   d. $740,000
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 in 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#58. Ariel Village issued the following bonds during the year ended June 30, 1983:

For installation of street lights, to be assessed against properties benefitted  
$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

D. Various Types of Not-for-Profit and Governmental Organizations

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.

41. For the year ended December 31, 1983, how much should Abbey record as patient service revenue?

a. $6,000,000  
b. $5,500,000  
c. $5,000,000  
d. $4,500,000

42. For the year ended December 31, 1983, Abbey should record the donation of bandages as

a. A $1,000 reduction in operating expenses.  
b. Nonoperating revenue of $1,000.  
c. Other operating revenue of $1,000.  
d. A memorandum entry only.

2M84#46. Cura Foundation, a voluntary health and welfare organization supported by contributions from
Selected Questions

the general public, included the following costs in its statement of functional expenses for the year ended December 31, 1983:

<table>
<thead>
<tr>
<th>Cost</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>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Fund-raising</td>
<td>$900,000</td>
</tr>
<tr>
<td>b. Administrative</td>
<td>$500,000</td>
</tr>
<tr>
<td>c. Research</td>
<td>$300,000</td>
</tr>
<tr>
<td>d. Curas' expenses</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

How much of the above-mentioned funds should be included in plant funds?

a. $0
b. $3,000,000
c. $5,000,000
d. $8,000,000

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</td>
<td>Endowment fund balance</td>
</tr>
<tr>
<td></td>
<td>$50,000</td>
</tr>
<tr>
<td>c. Cash</td>
<td>Endowment fund balance</td>
</tr>
<tr>
<td></td>
<td>$50,000</td>
</tr>
<tr>
<td>d. Cash</td>
<td>Nonexpendable endowment fund</td>
</tr>
<tr>
<td></td>
<td>$50,000</td>
</tr>
</tbody>
</table>

2M85#55. The following funds were among those on Kery University's books at April 30, 1984:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds to be used for acquisition</td>
<td></td>
</tr>
<tr>
<td>of additional properties for</td>
<td></td>
</tr>
<tr>
<td>University purposes (unexpended</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>at 4/30/84)</td>
<td></td>
</tr>
<tr>
<td>Funds set aside for debt service</td>
<td></td>
</tr>
<tr>
<td>charges and for retirement</td>
<td></td>
</tr>
<tr>
<td>of indebtedness on University</td>
<td></td>
</tr>
<tr>
<td>properties</td>
<td>$5,000,000</td>
</tr>
</tbody>
</table>

IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income

2M86#41. For assets acquired in 1986, the holding period for determining long-term capital gains and losses is more than

a. 6 months.
b. 9 months.
c. 12 months.
d. 15 months.

2M86#42. Fringe benefits received by an employee are generally subject to employment taxes or withholding

a. For statutory fringe benefits only.
b. If the fringe benefits are nonstatutory.
c. Regardless of the statutory or nonstatutory nature of the fringe benefits.
d. At the option of the employer.

2M86#45. Kirk Kory, a cash basis sole proprietor, had the following cash receipts and disbursements for 1985:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$120,000</td>
</tr>
<tr>
<td>Dividend income (on personal</td>
<td>800</td>
</tr>
<tr>
<td>investment)</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>60,000</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>12,000</td>
</tr>
<tr>
<td>State business tax</td>
<td>1,200</td>
</tr>
<tr>
<td>Federal self-employment tax</td>
<td>3,200</td>
</tr>
</tbody>
</table>

What amount should Kory report as net earnings from self-employment for 1985?

a. $43,600
b. $46,800
c. $47,600
d. $48,000

2M86#49. During the current year Hal Leff sustained a serious injury in the course of his employment. As a
result of this injury, Hal received the following payments during the year:

Worker’s compensation $2,400

Reimbursement from his employer’s accident and health plan for medical expenses paid by Hal and not deducted by him 1,800

Damages for personal injuries 8,000

The amount to be included in Hal’s gross income for the current year should be

a. $12,200
b. $ 8,000
c. $ 1,800
d. $ 0

2M86#52. Jason Budd, CPA, reports on the cash basis. In April 1984, Budd billed a client $3,500 for the following professional services:

Personal estate planning $2,000
Personal tax return preparation 1,000
Compilation of business financial statements 500

No part of the $3,500 was ever paid. In April 1986, the client declared bankruptcy, and the $3,500 obligation became totally uncollectible. What loss can Budd deduct on his 1986 tax return for this bad debt?

a. $0
b. $ 500
c. $1,500
d. $3,500

2N85

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

2N85#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

2N85#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.

2M85#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.

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:

\[
\begin{align*}
\text{Adjusted basis} & \\
\text{Land on which a storage shack is erected} & $3,000 \\
\text{Shack for storage of plumbing supplies} & 12,000
\end{align*}
\]

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:

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

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:

\[
\begin{align*}
\text{Gross receipts from business} & $120,000 \\
\text{Dividend income from personal investments} & 800 \\
\text{Cost of goods sold} & 60,000 \\
\text{Other business operating expenses} & 12,000 \\
\text{State business taxes} & 1,200 \\
\text{Federal self-employment tax} & 4,271
\end{align*}
\]

For the year ended December 31, 1984, how much should Krug report as net earnings from self-employment?

a. $42,529
b. $46,800
c. $47,600
d. $48,000
2N84#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 trace-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>

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

2N84#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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workers' compensation</td>
<td>$2,400</td>
</tr>
<tr>
<td>Reimbursement from employer's accident and health plan for medical expenses paid by Allen</td>
<td>1,800</td>
</tr>
<tr>
<td>Damages for personal injuries</td>
<td>8,000</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent for January to December 1983</td>
<td>$6,000</td>
</tr>
<tr>
<td>Advance rent for January 1984</td>
<td>$500</td>
</tr>
<tr>
<td>Security deposit, to be applied against the final three months' rent in the fifth year of the lease</td>
<td>1,500</td>
</tr>
</tbody>
</table>

Carl also received the following dividends in 1983, from:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual Life Insurance Co., on Carl's life insurance policy</td>
<td>$300</td>
</tr>
<tr>
<td>General Merchandise Corp., a Texas corporation, on preferred stock</td>
<td>400</td>
</tr>
<tr>
<td>Second National Bank, on bank's common stock</td>
<td>800</td>
</tr>
</tbody>
</table>

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
Selected Questions

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:

- Salary
  $20,000
- Interest on insurance dividends
  $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.

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 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.

37. How much taxable interest was received by John and Emma in 1983?
   a. $0
   b. $300
   c. $1,000
   d. $1,300

2N83#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.

2N83#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 |

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**Accounting Practice**

How much of this furniture comprises capital assets?

a. $0  
b. $8,000  
c. $12,000  
d. $20,000

2N83#36. Dr. Berger, a physician, reports on the cash basis. The following items pertain to Dr. Berger's medical practice in 1982:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from patients in 1982</td>
<td>$200,000</td>
</tr>
<tr>
<td>Cash received in 1982 from third-party</td>
<td></td>
</tr>
<tr>
<td>reimbursers for services provided by</td>
<td></td>
</tr>
<tr>
<td>Dr. Berger in 1981</td>
<td></td>
</tr>
<tr>
<td>Salaries paid to employees in 1982</td>
<td>$30,000</td>
</tr>
<tr>
<td>Year-end 1982 bonuses paid to employees</td>
<td>$20,000</td>
</tr>
<tr>
<td>in 1983</td>
<td>$1,000</td>
</tr>
<tr>
<td>Other expenses paid in 1982</td>
<td>$24,000</td>
</tr>
</tbody>
</table>

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

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>Description</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>Description</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 includable in her gross income. What is her adjusted gross income for 1982?

a. $38,000  
b. $41,200  
c. $42,800  
d. $46,000

1M83#45. The following information is available for Ann Drury for 1982:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$36,000</td>
</tr>
<tr>
<td>Premiums paid by employer on group-term life</td>
<td></td>
</tr>
<tr>
<td>insurance in excess of $50,000</td>
<td>$500</td>
</tr>
<tr>
<td>Proceeds from state lottery</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

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
B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

2M86#51. Joel Rich is an outside salesman, deriving his income solely from commissions, and personally bearing all expenses without reimbursement of any kind. During 1985, Joel paid the following expenses pertaining directly to his activities as an outside salesman:

- Travel $10,000
- Secretarial 7,000
- Telephone 1,000

How should these expenses be deducted in Joel’s 1985 return?

<table>
<thead>
<tr>
<th>From gross income, in arriving at adjusted gross income</th>
</tr>
</thead>
<tbody>
<tr>
<td>As itemized deductions</td>
</tr>
<tr>
<td>a. $18,000</td>
</tr>
<tr>
<td>b. $11,000</td>
</tr>
<tr>
<td>c. $10,000</td>
</tr>
<tr>
<td>d. $0</td>
</tr>
</tbody>
</table>

2N85 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

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 Korna 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

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.

Selected Questions

depth. Gus made the following payments to Ana in 1984:

- Lump-sum cash settlement $25,000
- Indefinite periodic payments 2,100

22. 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

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
2M84

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.

29. 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
   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

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

2M83/35. 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>

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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>Description</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

C. Gain or Loss on Property Transactions

2M86#44. At December 31, 1985, the following assets were among those owned by Eli York:

<table>
<thead>
<tr>
<th>Date acquired</th>
<th>Asset</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1984</td>
<td>Personal residence</td>
<td>$100,000</td>
</tr>
<tr>
<td>Feb. 1984</td>
<td>Stock of listed corp.</td>
<td>$8,000</td>
</tr>
<tr>
<td>Dec. 1985</td>
<td>Stock of listed corp.</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

How much were the capital assets?

a. $111,000  
b. $108,000  
c. $11,000  
d. $8,000

2M86

Items 54 and 55 are based on the following data:

In January 1985, Joan Hill bought one share of Orban Corp. stock for $300. On March 1, 1985, Orban distributed one share of preferred stock for each share of common stock held. This distribution was nontaxable. On March 1, 1985, Joan’s one share of common stock had a fair market value of $450, while the preferred stock had a fair market value of $150.

54. After the distribution of the preferred stock, Joan’s bases for her Orban stocks are

<table>
<thead>
<tr>
<th>Common</th>
<th>Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>$300</td>
<td>$0</td>
</tr>
<tr>
<td>$225</td>
<td>$75</td>
</tr>
<tr>
<td>$200</td>
<td>$100</td>
</tr>
<tr>
<td>$150</td>
<td>$150</td>
</tr>
</tbody>
</table>

55. The holding period for the preferred stock starts in


2M86#58. Pat Leif owned an apartment house that he bought in 1970. Depreciation was taken on a straight-line basis. In 1985, when Pat’s adjusted basis for this property was $200,000, he traded it for an office building having a fair market value of $600,000. The apartment house has 100 dwelling units, while the office building has 40 units rented to business enterprises. The properties are not located in the same city. What is Pat’s reportable gain on this exchange?

a. $400,000 Section 1250 gain.  
b. $400,000 Section 1231 gain.  
c. $400,000 long-term capital gain.  
d. $0.

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
Accounting Practice

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. $ 9,000
   d. $11,000

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.

2M84#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 $220,000. How much gain should Herr recognize in his 1984 income tax return?
   a. $0
   b. $ 80,000
   c. $150,000
   d. $330,000

2M83#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

D. Deductions From Adjusted Gross Income

2M86#53. The zero bracket amount is
   a. The equivalent of the excess itemized deductions.
   b. Built into the tax tables but not the tax rate schedules.
   c. Based on the taxpayer’s filing status regardless of income.
   d. The amount that determines whether or not an individual is required to file an income tax return.

2M86#56. Gail and Jeff Payne are married and filed a joint return for 1985. In 1985 they paid the following doctors’ bills for

   Gail’s mother, who received over half of her support from Gail and Jeff, but who does not live in the Payne household, and who earned $1,100 in 1985 for baby-sitting. $700
   Their unmarried 26-year old son, who earned $4,000 in 1985, but was fully supported by his parents. He is not a full-time student. 500

Disregarding the adjusted gross income percentage test, how much of these doctors’ bills may be included on the Paynes’ joint return in 1985 as qualifying medical expenses?
   a. $0
   b. $ 500
   c. $ 700
   d. $1,200

2M86#57. Medical and dental expenses are deductible only to the extent that they exceed a certain percentage of adjusted gross income. This percentage is
   a. 3%
   b. 5%
   c. 6%
   d. 10%

2M86#60. Edna Green, who is single, had an adjusted gross income of $30,000 in 1985. Edna contributed $100 to the alumni fund of State University in 1985, but did not itemize her deductions for 1985. How much can she deduct for contributions on her 1985 return?
   a. $0
   b. $ 25
   c. $ 50
   d. $100

2N85

Items 34 through 36 are based on the following data:

During 1984 Burt Knox made the following unreimbursed personal expenditures:

<table>
<thead>
<tr>
<th>Expense Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on note payable to a bank;</td>
<td>$1,000</td>
</tr>
<tr>
<td>proceeds of loan were used to buy municipal bonds</td>
<td></td>
</tr>
<tr>
<td>Payments pertaining to condominium apartment occupied by Burt:</td>
<td></td>
</tr>
<tr>
<td>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>
</tbody>
</table>
State and city gasoline taxes 150
State hunting license fee 25
Legal fee for preparation of will 100
Education expenses to qualify for new occupation 975

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

2N85#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

2N85
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 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

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

Selected Questions

39. How much was deductible in Gene's 1984 return as a casualty loss?
   a. $0
   b. $100
   c. $3,900
   d. $4,000

Also in 1984, Gene suffered a $4,000 loss due to vandalism, for which Gene had no insurance. Gene itemized his deductions for 1984.

2N84
Items 22 through 26 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:

- Medical insurance premiums $300
- Dental surgery 5,000

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

AP-121
State and city gasoline taxes 180
Medical insurance premiums 300
Unreimbursed dental premiums 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

2M84 #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

2M84
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

33. How much could Roger deduct in 1983 for the casualty loss?
   a. $0
   b. $100
   c. $300
   d. $400
Selected Questions

2M83

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 reality 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. $4,300
   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

E. Filing Status and Exemptions

2M86#46. In Mona Lux's 1985 income tax return, Mona validly claimed the $1,040 personal exemption for her dependent 17-year old son, Brett. Since Brett earned $5,000 in 1985 selling novelties at the college he attended full time, Brett was also required to file a 1985 income tax return. How much should Brett claim as a personal exemption in his 1985 individual income tax return?
   a. $0
   b. $520
   c. $1,000
   d. $1,040

2M86#59. Nell Brown's husband died in 1982. Nell did not remarry, and continued to maintain a home for herself and her dependent infant child during 1983,
1984, and 1985, providing full support for herself and her child during these three years. For 1982, Nell properly filed a joint return. For 1985, Nell's filing status is
a. Single.
b. Married filing joint return.
c. Head of household.
d. Qualifying widow with dependent child.

2M85#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:

Cousin
Niece
Foster parent

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.

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</td>
<td>$8,000</td>
</tr>
<tr>
<td>unrelated friend</td>
<td></td>
</tr>
<tr>
<td>Interest on income tax refund</td>
<td>100</td>
</tr>
<tr>
<td>Interest on life insurance policy's</td>
<td></td>
</tr>
<tr>
<td>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>

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>Person</th>
<th>Amount</th>
<th>Percent of support</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alma (an unrelated friend)</td>
<td>$2,400</td>
<td>48</td>
</tr>
<tr>
<td>Ben (Sara's brother)</td>
<td>2,150</td>
<td>43</td>
</tr>
<tr>
<td>Carl (Sara's son)</td>
<td>450</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>$5,000</td>
<td>100</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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$20,000</td>
</tr>
<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.

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
Selected Questions

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#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.

F. Tax Computations and Credits

2M66#43. If a taxpayer qualifies for the earned income credit, such credit can be subtracted from
   a. Gross income to arrive at adjusted gross income.
   b. Adjusted gross income to arrive at taxable income after personal exemptions.
   c. The tax owed, or can result in a refund, but only if the taxpayer had tax withheld from wages.
   d. The tax owed, or can result in a refund, even if the taxpayer had no tax withheld from wages.

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.

2N85#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.
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

2M84

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.

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

G. Statute of Limitations

2N85#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
   a. December 31, 1987
   b. March 15, 1988
   c. April 15, 1988
   d. June 15, 1988

2N84#38. Ronald Raff filed his 1983 individual income tax return on January 15, 1984. There was no understatement 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

2M86
Items 47 and 48 are based on the following data:

On July 31, 1985, Kim Reed received listed stock as an inheritance from her mother, Nora, who died on January 1, 1985. Nora’s adjusted basis for this stock was $50,000. This stock had a fair market value of $60,000 on January 1, 1985, and $65,000 on July 31, 1985. The alternate valuation was not elected. Kim’s adjusted gross income for 1985 was $20,000 before any consideration of her inheritance.

47. How much should Kim report in her 1985 return as adjusted gross income?
   a. $20,000
   b. $70,000
   c. $80,000
   d. $85,000

48. Kim’s basis for the inherited stock is
   a. $0
   b. $50,000
   c. $60,000
   d. $65,000

2N85#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:

<table>
<thead>
<tr>
<th>Time</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>At the date of Fred’s death</td>
<td>$400,000</td>
</tr>
<tr>
<td>Six months after Fred’s death</td>
<td>450,000</td>
</tr>
<tr>
<td>Nine months after Fred’s death</td>
<td>480,000</td>
</tr>
</tbody>
</table>

Ida’s basis for this stock is
   a. $380,000
   b. $400,000
   c. $450,000
   d. $480,000

2N85#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.

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:

- 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
- Dividends 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 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.

39. Kim’s basis for the 100 shares of Ral stock was
   a. $0
   b. $1,000
   c. $8,000
   d. $10,000

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2N84#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.

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.

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

2N84
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>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$20,000</td>
</tr>
<tr>
<td>Interest on insurance dividends</td>
<td></td>
</tr>
<tr>
<td>left on deposit with a life</td>
<td></td>
</tr>
<tr>
<td>insurance company</td>
<td>100</td>
</tr>
<tr>
<td>Interest on federal income tax</td>
<td></td>
</tr>
<tr>
<td>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.

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
Selected Questions

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

A. Determination of Taxable Income or Loss

2M87#42. For the year ended December 31, 1987, Sol Corp. had an operating income of $20,000. In addition, Sol had capital gains and losses resulting in a net short-term capital gain of $2,000 and a net long-term capital loss of $7,000. How much of the excess of net long-term capital loss over net short-term capital gain could Sol offset against ordinary income for 1987?
   a. $5,000
   b. $3,000
   c. $1,500
   d. $0

2M87#46. Which one of the following is a capital asset?
   a. Delivery truck.
   b. Goodwill.
   c. Land used as a parking lot for customers.
   d. Treasury stock, at cost.

2M87
Items 47 through 49 are based on the following data:

Ram Corp. ’s operating income for the year ended December 31, 1987 amounted to $100,000. In addition, Ram received $2,000 in dividends from an unrelated taxable domestic corporation in 1987. Included in Ram’s 1987 operating expenses is a $6,000 insurance premium on a policy insuring the life of Ram’s president. Ram is beneficiary of this policy. Also in 1987, a machine owned by Ram was completely destroyed in an accident. This machine’s adjusted basis immediately before the casualty was $15,000. The machine was not insured and had no salvage value.

47. In Ram’s 1987 tax return, what amount should be included in taxable income for the dividends?
   a. $300
   b. $400
   c. $1,600
   d. $1,700

48. In Ram’s 1987 tax return, what amount should be deducted for the $6,000 life insurance premium?
   a. $6,000
   b. $5,000
   c. $1,000
   d. $0

49. In Ram’s 1987 tax return, what amount should be deducted for the casualty loss?
   a. $5,000
   b. $5,400
   c. $14,900
   d. $15,000

2M87#50. For the first taxable year in which a corporation has qualifying research and experimental expenditures, the corporation
   a. Has a choice of either deducting such expenditures as current business expenses, or capitalizing these expenditures.
   b. Has to treat such expenditures in the same manner as they are accounted for in the corporation’s financial statements.
   c. Is required to deduct such expenditures currently as business expenses or lose the deductions.
   d. Is required to capitalize such expenditures and amortize them ratably over a period of not less than 60 months.

2N86#41. Al Eng owns 55% of the outstanding stock of Rego Corp. During 1986, Rego sold a trailer to Eng for $10,000. The trailer had an adjusted tax basis of $12,000, and had been owned by Rego for three years. In its 1986 income tax return, what is the allowable loss that Rego can claim on the sale of this trailer?
   a. $0
   b. $2,000 ordinary loss.
   c. $2,000 Section 1231 loss.
   d. $2,000 Section 1245 loss.

2N86#42. In 1985, Nam Corp., which is not a dealer in securities, realized taxable income of $160,000 from its business operations. Also in 1985, Nam sustained a long-term capital loss of $24,000 from the sale of marketable securities. Nam did not realize any other capital gains or losses since it began operations. In Nam’s income tax returns, what is the proper treatment for the $24,000 long-term capital loss?
   a. Use $3,000 of the loss to reduce 1985 taxable income, and carry $21,000 of the long-term capital loss forward for five years.
   b. Use $6,000 of the loss to reduce 1985 taxable income by $3,000, and carry $18,000 of the long-term capital loss forward for five years.
   c. Use $24,000 of the long-term capital loss to reduce 1985 taxable income by $12,000.
   d. Carry the $24,000 long-term capital loss forward for five years, treating it as a short-term capital loss.

2N86#44. In 1985, Daly Corp. had the following income:

<table>
<thead>
<tr>
<th></th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit from operations</td>
<td></td>
</tr>
<tr>
<td>Dividends from unrelated</td>
<td>1,000</td>
</tr>
<tr>
<td>taxable domestic</td>
<td></td>
</tr>
<tr>
<td>corporation</td>
<td></td>
</tr>
</tbody>
</table>

In Daly’s 1985 taxable income, how much should be included for the dividends received?
   a. $0
   b. $150
   c. $850
   d. $1,000
2N86#48. Parent Corp. and Subsidiary Corp. filed consolidated returns on a calendar-year basis. In January 1985, Subsidiary sold land, which it had used in its operations, to Parent for $75,000. Immediately before this sale, Subsidiary’s basis for the land was $45,000. Parent held the land primarily for sale to customers in the ordinary course of business. In July 1986, Parent sold the land to Dubin, an unrelated individual, for $90,000. In determining the consolidated Section 1231 net gain for 1986, how much should Subsidiary take into account as a result of the 1985 sale of the land from Subsidiary to Parent?
   a. $45,000
   b. $30,000
   c. $22,500
   d. $15,000

2N86#49. For the year ended December 31, 1985, Kork Corp.’s book income, before federal income taxes, was $300,000. Included in this $300,000 were the following items:

| Provision for state corporation income tax | $3,000 |
| Interest income on United States obligations | 8,000 |
| Interest paid on loan to carry United States obligations | 2,000 |

How much was Kork’s 1985 taxable income?
   a. $292,000
   b. $294,000
   c. $300,000
   d. $303,000

2N86#51. Moss Corp.’s income statement for 1985 showed the following expenses for life insurance premiums:

| Group-term life insurance premiums paid on employees’ lives with the employees’ dependents as beneficiaries | $10,000 |
| Term life insurance premiums paid on life of Moss’ president, with Moss Corp. as beneficiary | 7,000 |

On its 1985 tax return, how much should Moss deduct for life insurance premiums?
   a. $0
   b. $7,000
   c. $10,000
   d. $17,000

2N86

Items 59 and 60 are based on the following data:

Blu Corp. had operating income of $80,000, after deducting $5,000 for contributions to the state university, but not including dividends of $1,000 received from nonaffiliated taxable domestic corporations.

59. In computing the maximum allowable deduction for contributions, how much is the base amount to which Blu should apply the percentage limitation?
   a. $81,000
   b. $85,000
   c. $85,150
   d. $86,000

60. In applying the percentage limitation to the base amount, in order to compute the maximum allowable deduction for contributions, what percentage should Blu use?
   a. 5%
   b. 10%
   c. 30%
   d. 50%

2N85#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

2N85#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.

2N85#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

2N85#47. Thor Corporation’s operating income for 1984 was $300,000, after consideration of $50,000 for
Selected Questions

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

2N85#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 third preceding year.  
c. May be carried back to the third preceding year.  
d. Reduces the corporation’s capital loss carryback for that year.

2N85#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.

2N85#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.

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:

Sale of treasury stock to unrelated broker:

<table>
<thead>
<tr>
<th>Proceeds received</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>70,000</td>
</tr>
<tr>
<td>Par value</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Dividends received from unaffiliated taxable domestic corporations 3,000

Long-term capital gains on sale of stock of unrelated corporations 12,000

Short-term capital losses on sale of stock of unrelated corporations 30,000

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:

Sales price to Carr 40,000

Adjusted basis to Aki 44,000

Insurance premiums paid on policy insuring the life of Luke Ross, Aki’s president (Aki is beneficiary of policy) 9,000

Cash dividends paid on outstanding 10% cumulative preferred stock 20,000

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) 6,000

Amortization of organizational expenditures being written off over a 10-year period for financial statement purposes 1,000

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.
Accounting Practice

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

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
- Dividends income from unaffiliated domestic taxable corporations 2,000
- 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.

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

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.
Selected Questions

2M84#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.

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.

8. How much was Pym’s gain on the distribution?
a. $9,000  
b. $4,000  
c. $2,000  
d. $0

2M84#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:

Printing of stock certificates  $ 5,000  
Underwriters’ commissions on sale of stock 100,000

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#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 300 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

2N83#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:

<table>
<thead>
<tr>
<th>Number</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>$ 10</td>
</tr>
<tr>
<td>4</td>
<td>$ 25</td>
</tr>
<tr>
<td>4</td>
<td>$ 50</td>
</tr>
<tr>
<td>5</td>
<td>$100</td>
</tr>
</tbody>
</table>

How much of these gifts was deductible as a business expense for 1982?
a. $840  
b. $365  
c. $140  
d. $0
Accounting Practice

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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></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:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivery truck</td>
<td>$12,000</td>
</tr>
<tr>
<td>Land used as parking</td>
<td></td>
</tr>
<tr>
<td>lot for customers</td>
<td>20,000</td>
</tr>
</tbody>
</table>

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

B. Tax Computations and Credits

2M87#51. A corporation may reduce its income tax by taking a tax credit for
   a. Accelerated depreciation.
   b. State income taxes.
   c. Foreign income taxes.
   d. Dividends-received exclusion.

2N86#43. A corporation may reduce its income tax by taking a tax credit for
   a. Excess charitable contributions.
   b. State income taxes.
   c. Political contributions.
   d. Foreign income taxes.

2N85#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.

2N85#55. Reproduced below are the 1984 corporate tax rates:

If the amount on Form 1120, Line 30, Enter on Form 1120, Schedule J, Line 3:
Page 1 is:

<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

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.
Selected Questions

2MB4#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.

2N83#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

C. S Corporations

2M87#43. Bow, Inc., an S corporation, has three equal stockholders. For the year ended December 31, 1987, Bow had taxable income and current earnings and profits of $300,000. Bow made cash distributions totaling $120,000 during 1987. For 1987, what amount from Bow should be included in each stockholder's gross income?
   a. $140,000  
   b. $100,000  
   c. $60,000  
   d. $40,000

2N86#50. What is the maximum number of stockholders allowable for eligibility as an S corporation?
   a. 5  
   b. 15  
   c. 25  
   d. 35

2N86#58. With regard to S corporations and their stockholders, the "at-risk" rules applicable to losses
   a. Apply at the shareholder level rather than at the corporate level.
b. Depend on the number of persons owning the S corporation’s stock.
c. Take into consideration the character of the S corporation’s income.
d. Are subject to the elections made by the S corporation’s stockholders.

2N85#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

2N85#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

2N85#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.

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.

2N83#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

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2N83#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.

D. Personal Holding Companies

2M87#44. Kee Holding Corp. has 80 unrelated equal stockholders. For the year ended December 31, 1987, Kee’s income comprised the following:

   Net rental income $ 1,000
   Commissions earned on sales of franchises 3,000
   Dividends from taxable domestic corporations 90,000

Deductible expenses for 1987 totaled $10,000. Kee paid no dividends for the past three years. Kee’s liability for personal holding company tax for 1987 will be based on
   a. $12,000
   b. $11,000
   c. $ 9,000
   d. $0

2N86#46. Neel Corp. has one preferred stockholder and three common stockholders. Neel derives all of its income from investments in stocks and securities, and regularly distributes 51% of its taxable income as dividends to its stockholders. Neel is a (an)
   a. Regulated investment company.
   b. S corporation.
   c. Corporation subject to the accumulated earnings tax.
   d. Personal holding company.

2N85#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.

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.

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 accumulated earnings tax.
   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 equal stockholders.
   b. Applies regardless of the extent of dividend distributions.
   c. Should be self-assessed by filing a separate schedule along with the regular tax return.
   d. May apply if at least 20% of the corporation’s gross receipts constitute passive investment income.

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 following:

   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
Selected Questions

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

E. Accumulated Earnings Tax

2M87#41. The accumulated earnings tax is not imposed on corporations that
a. Are personal holding companies.
b. Are subsidiary corporations.
c. Have assets with an aggregate book value of less than $1,000,000.
d. Have more than 100 stockholders.

2M86#47. The accumulated earnings tax can be imposed
a. Regardless of the number of stockholders of a corporation.
b. On both partnerships and corporations.
c. On companies that make distributions in excess of accumulated earnings.
d. Only on parent-subsidiary affiliated groups.

2M85#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 stockholders.

2M85#43. The accumulated earnings tax
a. Depends on a stock ownership test based on the number of stockholders.
b. Can be avoided by sufficient dividend distributions.
c. Is computed by the filing of a separate schedule along with the corporation's regular tax return.
d. Is imposed when the entity is classified as a personal holding company.

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.

2N84#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

2N87#57. Mem Corp., which had earnings and profits of $500,000, made a nonliquidating distribution of property to its stockholders in 1987, as a dividend in kind. This property, which had an adjusted basis of $10,000 and a fair market value of $15,000 at the date of distribution, did not constitute assets used in the active conduct of Mem's business. How much gain did Mem have to recognize on this distribution?

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

2N85#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 shareholders 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
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 (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.

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

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

G. Tax-Free Incorporation

To qualify for tax-free incorporation, a sole proprietor must be in control of the transferee corporation immediately after the exchange of the proprietor’s assets for the corporation’s stock. “Control” for this purpose means ownership of stock amounting to at least
   a. 80.00%
   b. 66.67%
   c. 51.00%
   d. 50.00%

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:

- Cash: $5,000
- Office furniture and equipment:
  - Adjusted basis: $35,000
  - Fair market value: $45,000

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

In 1982, Dr. Ernest Griffiths, a cash basis taxpayer, incorporated his medical practice. No liabil-
Selected Questions

Basis

| Cash | $20,000 |
| Equipment: | 
| Adjusted basis | $140,000 |
| Fair market value | $180,000 |

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

II. Reorganizations

2M87#58. With regard to corporate reorganizations, which one of the following statements is correct?

a. A mere change in identity, form, or place of organization of one corporation does not qualify as a reorganization.
b. The reorganization provisions can not be used to provide tax-free treatment for corporate transactions.
c. Securities in corporations not parties to a reorganization are always "boot."
d. A "party to the reorganization" does not include the consolidated company.

2M86#45. Which one of the following is not a corporate reorganization as defined in the Internal Revenue Code?

a. Stock redemption.
b. Recapitalization.
c. Mere change in identity.
d. Statutory merger.

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>$66,000</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>

2M84#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

a. $0
b. $1,000
c. $1,800
d. $2,200

I. Liquidations and Dissolutions

2M87#59. In 1987, Acf Corp. adopted a plan of complete liquidation. Distributions to stockholders in 1987, under this plan of complete liquidation, included marketable securities purchased in 1980 with a basis of $100,000 and a fair market value of $120,000 at the date of distribution. On June 30, 1987, the date this plan of complete liquidation was adopted, Acf had 100 equal stockholders, and the fair market value of all of Acf's outstanding stock was $12,000,000. In Acf's 1987 return, what amount should be reported as long-term capital gain?

a. $20,000
b. $10,000
c. $8,000
d. $0

2M85#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.

2M84#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 liquidation. Two months later, Day paid all of its liabilities and distributed its remaining assets to Lark. These assets consisted of the following:

| Cash | $50,000 |
| Land (at cost) | 10,000 |

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. $55,000
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?

- $0.
- $150,000 capital gain.
- $150,000 Section 1231 gain.
- $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:

- Is available only if the corporation is collapsible.
- Can be in partial redemption of the corporation's capital stock.
- Results in the corporation's earnings and profits being taxed as an ordinary dividend to non-corporate stockholders.
- 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 Sesol Corp. Both companies were domestic corporations. Pursuant to a plan of liquidation adopted by Sesol in March 1983, Sesol distributed all of its property in September 1983, in complete redemption of all its stock, when Sesol’s accumulated earnings equaled $18,000. Sesol had never been insolvent. Pursuant to the liquidation, Sesol 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 Sesol recognize in 1983 on the transfer of this land to Pearl?

- $0.
- $18,000 gain.
- $27,000 gain.
- $30,000 gain.

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>Asset Description</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$22,500</td>
<td></td>
</tr>
<tr>
<td>Securities</td>
<td></td>
<td>$37,500</td>
</tr>
<tr>
<td>Total</td>
<td>$60,000</td>
<td></td>
</tr>
</tbody>
</table>

How much should Blum report as dividend income in 1982?

- $0.
- $22,500 gain.
- $30,000 gain.
- $45,000 gain.

2M87#53. Ben Krug, sole proprietor of Krug Dairy, hired Jan Karl in 1980 for an agreed salary and the promise of a 10% partnership capital interest if Karl continued in Krug’s employ until the end of 1986. On January 1, 1987, when the fair value of the business was $300,000, the partnership was formed as agreed. On what amount will Karl have to pay tax in 1987 for the partnership capital interest received by him?

- $0.
- $12,000.
- $18,000.
- $30,000.

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?

- $20,000.
- $14,000.
- $6,000.
- $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 50% 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?

- $0.
- $80,000 ordinary income.
- $80,000 long-term capital gain.
- $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

K. Basis of Partner's Interest

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

2M84#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

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
L. Determination of Partner’s Taxable Income and Partner’s Elections

2N85#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.

2N84#54. The partnership of Martin & Clark sustained an ordinary loss of $84,000 in 1983. The partnership, 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.

2M84#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

2M83#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.

M. Accounting Periods of Partnership and Partners

2N86#52. Without obtaining prior approval from the IRS, a newly formed partnership may adopt
a. A taxable year which is the same as that of all of its principal partners.
b. A calendar year, only if it comprises a 12-month period.
c. A January 31 year-end if it is a retail enterprise, and all of its principal partners are on a calendar year.
d. Any taxable year that it deems advisable to select.

N. Partner Dealing With Own Partnership

2M87#55. In March 1987, Lou Cole bought 100 shares of a listed stock for $10,000. In May 1987, Cole sold this stock, for its fair market value of $16,000, to the partnership of Rook, Cole & Clive. Cole owned a one-third interest in this partnership. In Cole’s 1987 tax return, what amount should be reported as short-term capital gain as a result of this transaction?

a. $6,000
b. $4,000
c. $2,000
d. $0

2N85#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.

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.

2N83#52. In computing the ordinary income of a partnership, a deduction is allowed for
a. The net operating loss deduction.
b. Contributions to recognized charities.
c. Partners’ personal exemptions.
d. Guaranteed payments to partners.
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#54. The basis of property (other than money) distributed by a partnership to a partner, in complete liquidation of the partner's interest, shall be an amount equal to the

- a. Adjusted basis of such partner's interest in the partnership, increased by any money distributed in the same transaction.
- b. Adjusted basis of such partner's interest in the partnership, reduced by any money distributed in the same transaction.
- c. Fair market value of the property.
- d. Book value of the property.

2M85#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.

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

2M83#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 Shaw &amp; Zack</th>
<th>Land — Tract &quot;A&quot;</th>
<th>$24,000</th>
<th>Land — Tract &quot;B&quot;</th>
<th>8,000</th>
</tr>
</thead>
</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

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

2M85#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 sales 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.
**Accounting Practice**

**2N85#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.

**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>
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<tbody>
<tr>
<td>Cash</td>
<td>$51,000</td>
<td>$51,000</td>
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<tr>
<td>Accounts receivable</td>
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<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>
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<tr>
<td>Capital accounts:</td>
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<tr>
<td></td>
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<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  
   c. October 31, 1982  
   d. December 31, 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?

a. April 30, 1983  
   b. December 31, 1982  
   c. July 31, 1982  
   d. July 1, 1982

**R. Types of Organizations**

**2M87#60.** The private foundation status of an exempt organization will terminate if it

a. Does not distribute all of its net assets to one or more public charities.
b. Qualifies as an exempt operating foundation.
c. Becomes a public charity.
d. Is governed by a charter that limits the organization's exempt purposes.

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Selected Questions

2N86#55. Which one of the following types of organizations qualifies as an organization exempt from income tax?

a. All "feeder" organizations, primarily conducting businesses for profit, but distributing 100% of their profits to organizations exempt from taxation.

b. A social club, supported solely by members' dues and members' purchases of food and drink for consumption on club premises, with 100% of the club's profits used for its recreational facilities.

c. A private foundation organized to influence legislation pertaining to protection of the environment.

d. A business league operated primarily to publish a yearbook comprised of members' paid advertisements, solicited by paid employees.

S. Requirements for Exemption

2M87#52. To qualify as an exempt organization, the applicant

a. Need not be specifically identified as one of the classes upon which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.

b. Must be classified as a social club.

c. Must file a written application with the Internal Revenue Service, even where no official forms are provided.

d. Must meet the tests that permit donors to deduct their contributions on their individual or corporate tax returns.

2N86#56. To qualify as an exempt organization,

a. A written application need not be filed if no applicable official form is provided.

b. No employee of the organization is permitted to receive compensation in excess of $100,000 per year.

c. The applicant must be of a type specifically identified as one of the classes upon which exemption is conferred by the Code.

d. The organization is prohibited from issuing capital stock.

T. Unrelated Business Income

2M87#56. If an exempt organization is a corporation, the tax on unrelated business taxable income is

a. Computed at corporate income tax rates.

b. Computed at rates applicable to trusts.

c. Treated as a credit against the tax on recognized capital gains.

d. Abated.

2N86#57. With regard to unrelated business income of an exempt organization, which one of the following statements is true?

a. If an exempt organization has any unrelated business income, such organization automatically forfeits its exempt status for the particular year in which such income was earned.

b. When an unrelated trade or business activity results in a loss, such activity is excluded from the definition of unrelated business.

c. If an exempt organization derives income from conducting games of chance, in a locality where such activity is legal, and in a state that confines such activity to nonprofit organizations, then such income is exempt from the tax on unrelated business income.

d. Dividends and interest earned by all exempt organizations always are excluded from the definition of unrelated business income.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

C. Statement of Changes in Financial Position

E. Consolidated Financial Statements

A. Cash, Marketable Securities, and Investments

B. Receivables and Accruals

C. Inventories

D. Property, Plant, and Equipment Owned or Leased

AP-147
## Accounting Practice

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

#### A. Payables and Accruals

<table>
<thead>
<tr>
<th></th>
<th>B. Deferred Revenues</th>
<th>D. Capitalized Lease Liability</th>
<th>E. Bonds Payable</th>
<th>F. Contingent Liabilities and Commitments</th>
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#### C. Deferred Income Tax Liabilities

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<th></th>
<th>B. Deferred Revenues</th>
<th>D. Capitalized Lease Liability</th>
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### IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

#### A. Preferred and Common Stock

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#### C. Retained Earnings and Dividends

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### V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

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Unofficial Answers

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G. Breakeven and Cost-Volume-Profit Analysis

H. Capital Budgeting Techniques

J. Other

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I. Performance Analysis

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B. Types of Funds and Fund Accounts

D. Various Types of Not-for-Profit and Governmental Organizations

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Accounting Practice

B. Exclusions and Adjustments to Gross Income

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D. Deductions From Adjusted Gross Income

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C. Gain or Loss on Property Transactions

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X. Federal Taxation—Corporations, Partnerships, and Exempt Organizations

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<td>41 c</td>
<td>56 b</td>
</tr>
<tr>
<td>55 d</td>
<td>42 c</td>
<td>53 c</td>
</tr>
</tbody>
</table>

D. Personal Holding Companies

<table>
<thead>
<tr>
<th>2N84#</th>
<th>2M84#</th>
<th>AP-152</th>
</tr>
</thead>
<tbody>
<tr>
<td>50 a</td>
<td>9 b</td>
<td></td>
</tr>
<tr>
<td>50 a</td>
<td>10 a</td>
<td></td>
</tr>
<tr>
<td>52 c</td>
<td></td>
<td>2N83#</td>
</tr>
<tr>
<td>46 d</td>
<td>60 c</td>
<td></td>
</tr>
</tbody>
</table>
## G. Tax-Free Incorporation
- 2M87#45 a
- 2M84#20 b
- 2M83#46 b

## J. Formation of Partnership
- 2M87#53 d
- 2M85#56 a
- 2N84# 45 a
- 2M84#17 b
- 2N83# 53 a

## M. Accounting Periods of Partnership and Partners
- 2N86# 52 a

## Q. Termination of Partnership
- 2N85# 59 b
- 2N85# 60 d
- 2N84# 42 c
- 2N84# 43 d
- 2M83#53 a
- 2M83#56 b
- 2M83#57 a

## H. Reorganizations
- 2M87#58 c
- 2N86# 45 a
- 2M85#54 d
- 2N84# 58 a

## K. Basis of Partner's Interest
- 2M87#54 a
- 2N86# 53 a
- 2M85#58 b
- 2N84# 55 c
- 2M84#19 b
- 2N83# 54 c
- 2M83#58 b

## O. Treatment of Liabilities
- 2M85#57 c

## S. Requirements for Exemption
- 2M87#52 c

## I. Liquidations and Dissolutions
- 2M87#59 a
- 2N85# 54 d
- 2M85#42 a
- 2M84# 6 a
- 2M84#15 c
- 2N85# 57 b
- 2N83# 51 a
- 2M84#47 c
- 2M83#60 b

## L. Determination of Partner's Taxable Income and Partner's Elections
- 2N86# 54 b
- 2N85# 58 c
- 2M85#60 d
- 2N83# 58 d
- 2M83#54 a
- 2M83#55 d
- 2M83#59 c

## T. Unrelated Business Income
- 2M87#56 a
- 2N86# 57 c
I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1987
Number 5 (Estimated time — — 40 to 50 minutes)
Presented below is information pertaining to Cox Stationery Supply, a calendar-year sole proprietorship owned by John Cox. The business maintains its books on the cash basis except that, at year end, the closing inventory and depreciation are recorded. On December 31, 1986, after recording inventory and depreciation, and closing the nominal accounts, Cox had the following general ledger trial balance:

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$16,500</td>
<td></td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>39,000</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>52,500</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td>$20,500</td>
</tr>
<tr>
<td>Note payable, bank</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td></td>
<td>1,300</td>
</tr>
<tr>
<td>Cox, capital</td>
<td></td>
<td>76,200</td>
</tr>
<tr>
<td></td>
<td>$108,000</td>
<td>$108,000</td>
</tr>
</tbody>
</table>

During the last quarter of 1986, John Cox and Mary Rice, an outside investor, agreed to incorporate the business under the name of Cox Stationers, Inc. Cox will receive 1,000 shares for his business, and Rice will pay $86,000 cash for her 1,000 shares. On January 1, 1987, they received the certificate of incorporation for Cox Stationers, Inc., and the corporation issued 1,000 shares of common stock each to Cox and Rice for the above consideration. The agreement between Cox and Rice requires that the December 31, 1986 balance sheet of the proprietorship should be converted to the accrual basis, with all assets and liabilities stated at current fair values, including Cox's goodwill implicit in the terms of the common stock issuance.

Additional information:

1. Amounts due from customers totaled $23,500 at December 31, 1986. A review of collectibility disclosed that an allowance for doubtful accounts of $3,300 is required.

2. The $39,000 merchandise inventory is based on a physical count of goods priced at cost. Unsalable damaged goods costing $2,500 are included in the count. The current fair value of the total merchandise inventory is $45,000.

3. On July 1, 1986, Cox paid $3,800 to renew the comprehensive insurance coverage for one year.

4. The $10,000 note payable is dated July 1, 1986, bears interest at 12%, and is due July 1, 1987.


6. During January 1987, final payroll tax returns filed for Cox Stationery Supply required remittances totaling $2,100.
Accounting Practice

7. Not included in the trial balance is the $3,500 principal balance at December 31, 1986, of the three-year loan to purchase a delivery van on December 31, 1984. The debt was assumed by the corporation on January 1, 1987. The current fair value of the used equipment is $40,000, including the delivery van.

8. Cox Stationers, Inc., has 7,500 authorized shares of $50 par common stock.

Required:

a. Prepare a schedule to compute Cox's goodwill implicit in the issuance to him of 1,000 shares of common stock for his business.

b. Prepare a formal balance sheet of Cox Stationers, Inc., at January 1, 1987, immediately after the issuance of common stock to Cox and Rice. Journal entries and trial balance worksheet are not required.

1M86
Number 5 (Estimated time — — 40 to 50 minutes)

Rand, Inc., a nonpublic enterprise, is negotiating a loan for expansion purposes and the bank requires audited financial statements. Before closing the accounting records for the year ended December 31, 1985, Rand's controller prepared the following comparative financial statements for 1985 and 1984:

Rand, Inc.
BALANCE SHEETS
December 31, 1985 and 1984

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$275,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Marketable securities, at cost</td>
<td>78,000</td>
<td>78,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>487,000</td>
<td>392,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(50,000)</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Inventories</td>
<td>425,000</td>
<td>307,000</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>310,000</td>
<td>217,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(150,000)</td>
<td>(121,000)</td>
</tr>
<tr>
<td>Total assets</td>
<td><strong>$1,375,000</strong></td>
<td><strong>$991,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities &amp; Stockholders' Equity</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable &amp; accrued liabilities</td>
<td>$420,000</td>
<td>$347,000</td>
</tr>
<tr>
<td>Estimated liability from lawsuit</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Common stock, $10 par</td>
<td>260,000</td>
<td>260,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>130,000</td>
<td>130,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>465,000</td>
<td>254,000</td>
</tr>
<tr>
<td>Total liabilities &amp; stockholders' equity</td>
<td><strong>$1,375,000</strong></td>
<td><strong>$991,000</strong></td>
</tr>
</tbody>
</table>

Rand, Inc.
INCOME STATEMENTS
For the Years Ended December 31, 1985 and 1984

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,580,000</td>
<td>$1,250,000</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>755,000</td>
<td>690,000</td>
</tr>
<tr>
<td>Selling &amp; administrative</td>
<td>485,000</td>
<td>365,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>29,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Estimated loss from lawsuit</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>1,369,000</strong></td>
<td><strong>1,073,000</strong></td>
</tr>
<tr>
<td>Net income</td>
<td><strong>$211,000</strong></td>
<td><strong>$177,000</strong></td>
</tr>
</tbody>
</table>

AP-156
### WORKSHEET FOR BALANCE SHEET AND INCOME STATEMENT

**December 31, 1985**

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Adjustments</th>
<th>Corrected Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$275,000</td>
<td></td>
</tr>
<tr>
<td>Marketable securities, at cost</td>
<td>$78,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$487,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>$(50,000)</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>$425,000</td>
<td></td>
</tr>
<tr>
<td>Property and equipment</td>
<td>$310,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$(150,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets:</strong></td>
<td><strong>$1,375,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

| Liabilities & Stockholders' Equity: | | |
| Accounts payable & accrued liabilities | $420,000 | | |
| Estimated liability from lawsuit | $100,000 | | |
| Common stock | $260,000 | | |
| Additional paid-in capital | $130,000 | | |
| **Retained earnings:** | | |
| Balance, 1/1/85 | $254,000 | | |
| Net income for 1985 | $211,000 | | |
| **Total Liabilities & Stockholders’ Equity:** | **$1,375,000** | | |

| Income Statement | | |
| Net sales | $(1,580,000) | | |
| Cost of sales | $755,000 | | |
| Selling & administrative expenses | $485,000 | | |
| Depreciation expense | $29,000 | | |
| Estimated loss from lawsuit | $100,000 | | |
| **Net income:** | **$(211,000)** | | |

**Rand, Inc.**
During the course of the audit, the following additional information was obtained:

1. The investment portfolio consists of short-term investments with a total market valuation of $81,000 at December 31, 1984, and $67,000 at December 31, 1985.

2. In discussion with company officials, it was determined that the doubtful accounts expense rate based on net sales should be reduced to 2% from 3% effective January 1, 1985.

3. As a result of errors in physical count, inventories were overstated by $12,000 at December 31, 1984, and by $17,500 at December 31, 1985.

4. On January 1, 1984, the cost of equipment purchased for $30,000 was debited to repairs and maintenance. Rand depreciates machines of this type by the straight-line method over a five-year life, with no residual value.

5. On July 1, 1985, fully depreciated equipment purchased for $21,000, was sold as scrap for $2,500. The only entry Rand made was to debit cash and credit property and equipment for the scrap proceeds. The property and equipment (net) had a current cost of $250,000 at December 31, 1985.

6. Advertising and promotion expense for the year ended December 31, 1984, includes the $25,000 cost of printing sales catalogs for a special promotional campaign in January 1985.

7. Rand was named as a defendant in a lawsuit in October 1985. Rand’s counsel is of the opinion that Rand has a good defense and does not anticipate any impairment of Rand’s assets or that any significant liability will be incurred. Nevertheless, Rand’s management wished to be conservative and established a loss contingency of $100,000 at December 31, 1985.

**Required (Ignore income taxes):**
Complete the tear-out worksheet to prepare a corrected balance sheet of Rand, Inc., as of December 31, 1985, and a corrected income statement for the year ended December 31, 1985. Formal statements and journal entries are not required. The worksheet adjustments should be numbered to correspond with the numbers in the additional information. Include the completed tear-out worksheet in the proper sequence with other answer sheets.
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></th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>18,500</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable, 12/31/82</td>
<td>4,500</td>
<td></td>
</tr>
<tr>
<td>Inventory, 12/31/82</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation, 12/31/82</td>
<td></td>
<td>9,000</td>
</tr>
<tr>
<td>Accounts payable, 12/31/82</td>
<td></td>
<td>4,800</td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td></td>
<td>850</td>
</tr>
<tr>
<td>Mary Ward, drawings</td>
<td>24,000</td>
<td></td>
</tr>
<tr>
<td>Mary Ward, capital, 12/31/82</td>
<td></td>
<td>33,650</td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>187,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>82,700</td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>29,500</td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>2,900</td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>8,400</td>
<td></td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>3,900</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>2,400</td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>3,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$235,300</td>
<td>$235,300</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:

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.
### Ward Specialty Foods

**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></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></td>
<td>$9,000</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>4,800</td>
<td></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></td>
<td>850</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></td>
<td>187,000</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>
Bryant Corporation was incorporated on December 1, 1981, and began operations one week later. Bryant is a nonpublic enterprise. Before closing the books for the fiscal year ended November 30, 1982, Bryant's controller prepared the following financial statements:

### Bryant Corporation

#### BALANCE SHEET

**November 30, 1982**

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$150,000</td>
</tr>
<tr>
<td>Marketable securities, at cost</td>
<td>60,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>450,000</td>
</tr>
<tr>
<td>Less allowance for doubtful accounts</td>
<td>(59,000)</td>
</tr>
<tr>
<td>Inventories</td>
<td>430,000</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>$1,046,000</td>
</tr>
<tr>
<td>Property, plant &amp; equipment</td>
<td>426,000</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Research &amp; development costs</td>
<td>120,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$1,552,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities &amp; Stockholders' Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Accounts payable &amp; accrued expenses</td>
<td>$592,000</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>224,000</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>816,000</td>
</tr>
<tr>
<td><strong>Stockholders' equity</strong></td>
<td></td>
</tr>
<tr>
<td>Common stock, $10 par value</td>
<td>400,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>336,000</td>
</tr>
<tr>
<td><strong>Total stockholders' equity</strong></td>
<td>736,000</td>
</tr>
<tr>
<td><strong>Total liabilities &amp; stockholders' equity</strong></td>
<td>$1,552,000</td>
</tr>
</tbody>
</table>

#### Bryant Corporation

#### STATEMENT OF INCOME

**For the Year Ended November 30, 1982**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$2,950,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>1,670,000</td>
</tr>
<tr>
<td>Selling &amp; administrative</td>
<td>650,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>40,000</td>
</tr>
<tr>
<td>Research &amp; development</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>2,390,000</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>560,000</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>224,000</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$336,000</td>
</tr>
</tbody>
</table>

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 ending 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:**

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><strong>Balance Sheet</strong></th>
<th><strong>Unadjusted Balance</strong></th>
<th><strong>Adjustments</strong></th>
<th><strong>Adjusted Balance</strong></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><strong>$ 1,552,000</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Liabilities &amp; Stockholders’ Equity:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable &amp; accrued expenses</td>
<td>$ (592,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>(224,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>(400,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(336,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities &amp; Stockholders’ Equity:</strong></td>
<td></td>
<td></td>
<td>$(1,552,000)</td>
</tr>
</tbody>
</table>

**Statement of Income**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$(2,950,000)</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>1,670,000</td>
</tr>
<tr>
<td>Selling &amp; administrative expenses</td>
<td>650,000</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>40,000</td>
</tr>
<tr>
<td>Research &amp; development expense</td>
<td>30,000</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>224,000</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$ (336,000)</td>
</tr>
</tbody>
</table>
B. Income Statement

The following trial balance of Garr Corporation at December 31, 1985, has been adjusted except for income tax expense.

Garr Corporation
TRIAL BALANCE
December 31, 1985

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 675,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>1,695,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>2,185,000</td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment (net)</td>
<td>8,660,000</td>
<td></td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td></td>
<td>$ 1,895,000</td>
</tr>
<tr>
<td>Income tax payable</td>
<td></td>
<td>360,000</td>
</tr>
<tr>
<td>Deferred income tax</td>
<td></td>
<td>285,000</td>
</tr>
<tr>
<td>Common stock</td>
<td></td>
<td>2,300,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td></td>
<td>3,675,000</td>
</tr>
<tr>
<td>Retained earnings, 1/1/85</td>
<td></td>
<td>3,350,000</td>
</tr>
<tr>
<td>Net sales — Regular</td>
<td></td>
<td>10,750,000</td>
</tr>
<tr>
<td>— Plastics Division</td>
<td></td>
<td>2,200,000</td>
</tr>
<tr>
<td>Cost of sales — Regular</td>
<td>5,920,000</td>
<td></td>
</tr>
<tr>
<td>— Plastics Division</td>
<td>1,650,000</td>
<td></td>
</tr>
<tr>
<td>Selling and administrative expenses — Regular</td>
<td>2,600,000</td>
<td>660,000</td>
</tr>
<tr>
<td>— Plastics Division</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income — Regular</td>
<td></td>
<td>65,000</td>
</tr>
<tr>
<td>Gain on litigation settlement — Regular</td>
<td></td>
<td>200,000</td>
</tr>
<tr>
<td>Depreciation adjustment from accounting change — Regular</td>
<td>350,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Gain on disposal of Plastics Division</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income tax expense</td>
<td>835,000</td>
<td></td>
</tr>
</tbody>
</table>

$25,230,000 $25,230,000

Other financial data for the year ended December 31, 1985:

Income tax expense

- Estimated tax payments $475,000
- Accrued 360,000
- Total charged to income tax expense (estimated) $835,000

Tax rate on all types of income 40%

Gain from litigation settlement is a taxable gain and is not considered infrequent.

The $835,000 does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for financial statement purposes.

Timing difference (not related to Plastics Division)

- Depreciation per tax return $750,000
- Depreciation per financial statements (excluding cumulative effect of accounting change) 575,000
Discontinued operations
On October 31, 1985, Garr sold its Plastics Division for $2,950,000 when the carrying amount was $2,800,000. For financial statement reporting, this sale was considered a disposal of a segment of a business. Since there was no phase-out period, the measurement date was October 31, 1985.

Change in depreciation method
On January 1, 1985, Garr changed to the 150% declining balance method from the straight-line method of depreciation for certain of its plant assets. The pretax cumulative effect of this accounting change was determined to be a charge of $350,000. There was no change in depreciation method for income tax purposes.

Capital structure
Common stock, $10 par, traded on a national exchange:

<table>
<thead>
<tr>
<th>Shares</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding</td>
<td>200,000</td>
</tr>
<tr>
<td>Issued on 7/1/85 as a 15% stock dividend</td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>230,000</td>
</tr>
</tbody>
</table>

Required:
Using the multiple-step format, prepare a formal income statement for Garr for the year ended December 31, 1985. All components of income tax expense should be appropriately shown.

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>$ 4,400,000</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>260,000</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>$30,735,000</td>
<td>$30,735,000</td>
</tr>
</tbody>
</table>
Selected Questions

Other financial data for the year ended December 31, 1984:

**Federal income tax**
- Estimated tax payments: $400,000
- Accrued: $200,000
- Total charged to income tax expense (estimated): $600,000*

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**
- Depreciation per tax return: $760,000
- Depreciation per books: 580,000

**Permanent difference**
- Premiums on officers' life insurance: $140,000

**Capital structure**
- Shares: Common stock, par value $10 per share, traded on a national exchange:
  - Number of shares outstanding at 1/1/84: 200,000
  - Number of shares issued on 3/30/84 as a 10% stock dividend: 20,000
  - Number of shares sold for $25 per share on 6/30/84: 30,000
  - Number of shares outstanding at 12/31/84: 250,000

**C. Statement of Changes in Financial Position**

1M87
Number 4 (Estimated time — 45 to 55 minutes)

Presented below are the consolidated workpaper balances of Bush, Inc., and its subsidiary, Dorr Corporation, as of December 31, 1986 and 1985.

<table>
<thead>
<tr>
<th>Assets</th>
<th>1986</th>
<th>1985</th>
<th>Net change increase (decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$313,000</td>
<td>$195,000</td>
<td>$118,000</td>
</tr>
<tr>
<td>Marketable equity securities, at cost</td>
<td>175,000</td>
<td>175,000</td>
<td>—</td>
</tr>
<tr>
<td>Allowance to reduce marketable equity securities to market</td>
<td>(13,000)</td>
<td>(24,000)</td>
<td>11,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>418,000</td>
<td>440,000</td>
<td>(22,000)</td>
</tr>
<tr>
<td>Inventories</td>
<td>595,000</td>
<td>525,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Land</td>
<td>385,000</td>
<td>170,000</td>
<td>215,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>755,000</td>
<td>690,000</td>
<td>65,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(199,000)</td>
<td>(145,000)</td>
<td>(54,000)</td>
</tr>
<tr>
<td>Goodwill, net</td>
<td>57,000</td>
<td>60,000</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Total assets</td>
<td>$2,486,000</td>
<td>$2,086,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

AP-165
**Liabilities and Stockholders' Equity**

<table>
<thead>
<tr>
<th>Description</th>
<th>1987</th>
<th>1987</th>
<th>—</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current portion of long-term note</td>
<td>$150,000</td>
<td>$150,000</td>
<td>—</td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>595,000</td>
<td>474,000</td>
<td>121,000</td>
</tr>
<tr>
<td>Note payable, long-term</td>
<td>300,000</td>
<td>450,000</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>44,000</td>
<td>32,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Minority interest in net assets of subsidiary</td>
<td>179,000</td>
<td>161,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Common stock, par $10</td>
<td>580,000</td>
<td>480,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>303,000</td>
<td>180,000</td>
<td>123,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>335,000</td>
<td>195,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Treasury stock, at cost</td>
<td>—</td>
<td>(36,000)</td>
<td>36,000</td>
</tr>
<tr>
<td>Total liabilities and stockholders' equity</td>
<td>$2,486,000</td>
<td>$2,086,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

**Additional information:**

- On August 8, 1986, equipment was purchased for $127,000.
- On September 30, 1986, equipment was sold for $40,000. The equipment cost $62,000 and had a carrying amount of $34,000 on the date of sale.
- 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 reporting.
- Net income for 1986 was as follows:
  - Consolidated net income: $198,000
  - Dorr Corporation: 110,000

- Bush, Inc., owns 70% of its subsidiary, Dorr Corporation. There was no change in the ownership interest in Dorr Corporation during 1985 and 1986. There were no intercompany transactions other than the dividend paid to Bush, Inc., by its subsidiary.

**Required:**

Using the cash concept of financial resources, prepare a consolidated statement of changes in financial position of Bush, Inc., and Subsidiary for the year ended December 31, 1986.
Presented below are the balance sheet accounts of Bergen Corporation as of December 31, 1983 and 1982.

Assets

<table>
<thead>
<tr>
<th></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></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.
- 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.

D. Statement of Owners’ Equity

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:

Common stock $20,000,000
Additional paid-in capital 7,500,000
Retained earnings 6,500,000

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.

2. Prepare the stockholders’ equity section of Ashwood’s balance sheet at December 31, 1982.


E. Consolidated Financial Statements or Worksheets

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:

AP-168
Selected Questions

<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>$13,795,000</td>
<td>$4,875,000</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 Equity</strong></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
</tr>
</tbody>
</table>

Additional information is as follows:

- On June 30, 1984, immediately before the combination, the stockholders' equities were:

<table>
<thead>
<tr>
<th>Case</th>
<th>Frey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$2,200,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,660,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,036,000</td>
</tr>
<tr>
<td><strong>Total Stockholders' Equity</strong></td>
<td>$6,896,000</td>
</tr>
</tbody>
</table>

- 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:

a. 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.

b. Prepare a formal consolidated statement of retained earnings for the year ended December 31, 1984.

AP-169
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></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&amp; other assets</td>
<td>865,000</td>
<td>385,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>**Liabilities and</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stockholders' Equity:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable &amp; other</td>
<td>$2,465,000</td>
<td>$1,145,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>current liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term debt</td>
<td>1,900,000</td>
<td>1,300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock, $25 par</td>
<td>3,200,000</td>
<td>1,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,850,000</td>
<td>190,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,380,000</td>
<td>1,240,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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</th>
<th>Taft</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. (Cr.)</td>
<td>Dr. (Cr.)</td>
<td></td>
</tr>
<tr>
<td>Net sales</td>
<td>$(1,900,000)</td>
<td>$(1,500,000)</td>
</tr>
<tr>
<td>Dividend income from</td>
<td></td>
<td></td>
</tr>
<tr>
<td>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></td>
<td></td>
</tr>
<tr>
<td>(includes depreciation)</td>
<td>550,000</td>
<td>440,000</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 ($10 par)</td>
<td>(1,200,000)</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>(140,000)</td>
<td>(80,000)</td>
</tr>
<tr>
<td>Retained earnings (1/1/82)</td>
<td>(220,000)</td>
<td>(156,000)</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
### Income Statement

<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

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></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>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 285,000</td>
<td>$ 150,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>430,000</td>
<td>350,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>530,000</td>
<td>410,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land, plant &amp; equipment</td>
<td>660,000</td>
<td>680,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(185,000)</td>
<td>(210,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Taft (at cost)</td>
<td>750,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$ 2,470,000</td>
<td>$ 1,380,000</td>
<td></td>
<td></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>Accounts pay. &amp; accrued exp.</td>
<td>$(670,000)</td>
<td>$(594,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>(1,200,000)</td>
<td>(400,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>(140,000)</td>
<td>(80,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>(460,000)</td>
<td>(306,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$(2,470,000)</td>
<td>$(1,380,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Selected Questions

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:

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

1N86
Number 4 (Estimated time — 45 to 55 minutes)

On December 31, 1984, Lee, Inc., reported as long-term investments the following marketable equity securities:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dale Corp., 5,000 shares</td>
<td>$125,000</td>
</tr>
<tr>
<td>stock (a 1% interest)</td>
<td></td>
</tr>
<tr>
<td>Ewing Corp., 10,000 shares</td>
<td>160,000</td>
</tr>
<tr>
<td>stock (a 2% interest)</td>
<td></td>
</tr>
<tr>
<td>Fox Corp., 25,000 shares</td>
<td>700,000</td>
</tr>
<tr>
<td>stock (a 10% interest)</td>
<td></td>
</tr>
<tr>
<td>Marketable equity securities at cost</td>
<td>985,000</td>
</tr>
<tr>
<td>Less valuation allowance to reduce long-term investments in marketable equity securities to market value</td>
<td>50,000</td>
</tr>
<tr>
<td>Marketable equity securities at market</td>
<td>$935,000</td>
</tr>
</tbody>
</table>

Additional information:

- On May 1, 1985, Dale issued a 10% stock dividend, when the market price of its stock was $24 per share.
- On November 1, 1985, Dale paid a cash dividend of $0.75 per share.
- On August 5, 1985, Ewing issued, to all shareholders, stock rights on the basis of one right per share. Market prices at date of issue were $13.50 per share (ex-rights) of stock and $1.50 per right. Lee sold all rights on December 16, 1985, for net proceeds of $18,800.
- On July 1, 1985, Lee paid $1,520,000 for 50,000 additional shares of Fox Corp.'s common stock which represented a 20% investment in Fox. The fair value of all of Fox's identifiable assets net of liabilities was equal to their carrying amount of $6,350,000. As a result of this transaction, Lee owns 30% of Fox and can exercise significant influence over Fox's operating and financial policies. Lee amortizes goodwill over a 40-year period.
- Lee's initial 10% interest of 25,000 shares of Fox's common stock was acquired on January 2, 1984, for $700,000. At that date the net assets of Fox totaled $5,800,000 and the fair value of Fox's identifiable assets net of liabilities was equal to their carrying amount.
- Market prices per share of the marketable equity securities, all listed on a national securities exchange, were as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>1984</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dale Corp. — common</td>
<td>22</td>
<td>23</td>
</tr>
<tr>
<td>Ewing Corp. — common</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>Fox Corp. — common</td>
<td>27</td>
<td>29</td>
</tr>
</tbody>
</table>


**Accounting Practice**

1N86

Number 4 (cont.)

- Fox reported net income and paid dividends of:

<table>
<thead>
<tr>
<th>Year ended 12/31/84</th>
<th>Net income</th>
<th>Dividends per share</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$350,000</td>
<td>None</td>
</tr>
<tr>
<td>Six months ended 6/30/85</td>
<td>200,000</td>
<td>None</td>
</tr>
<tr>
<td>Six months ended 12/31/85</td>
<td>370,000</td>
<td>$1.30</td>
</tr>
<tr>
<td>(Dividend was paid 10/1/85)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- There were no other intercompany transactions between Lee and Fox.

**Required:**

a. Prepare a schedule setting forth for each investment the transactions and computations necessary to determine the ending balance in Lee's December 31, 1985, balance sheet:
   1. For investments carried at the lower of cost or market.
   2. For investments carried under the equity method of accounting.

b. Prepare a schedule showing all income, gains, and losses relating to Lee's long-term investments for the year ended December 31, 1985.

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:

- Bea Corp. — 1,000 shares, $2.40 convertible preferred stock $ 40,000
- Cha, Inc. — 6,000 shares of common stock 60,000
- Dey Co. — 2,000 shares of common stock 55,000

Marketable equity securities at cost $155,000
Less valuation allowance 7,000
Marketable equity securities at market $148,000

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:

<table>
<thead>
<tr>
<th></th>
<th>At December 31,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1983</td>
</tr>
<tr>
<td>Bea Corp. — preferred</td>
<td>$56</td>
</tr>
<tr>
<td>Bea Corp. — common</td>
<td>20</td>
</tr>
<tr>
<td>Cha, Inc. — common</td>
<td>11</td>
</tr>
<tr>
<td>Dey Co. — common</td>
<td>22</td>
</tr>
<tr>
<td>Eddie Corp. — common</td>
<td>16</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.

**B. Receivables and Accruals**

1N84

Number 5 (Estimated time — 40 to 50 minutes)

Linden, Inc., had the following long-term receivable account balances at December 31, 1982:
Selected Questions

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, 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 paid 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 bearing 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.

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>Classification by 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

Number 4 consists of two unrelated parts.

Accounting Practice

1M83
Number 4 (cont.)

for income tax and external financial statements reporting purposes. However, Lucas continued to use the FIFO inventory method for internal accounting and management purposes. In applying the LIFO method Lucas uses internal conversion price indexes and the multiple-pools approach under which substantially identical inventory items are grouped into LIFO inventory pools. The following data were available for Inventory Pool No. 1, which is composed of products A and B, for the two years following the adoption of LIFO:

<table>
<thead>
<tr>
<th>FIFO basis per records</th>
<th>Units</th>
<th>Unit cost</th>
<th>Total cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/81</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product A</td>
<td>12,000</td>
<td>$30</td>
<td>$360,000</td>
</tr>
<tr>
<td>Product B</td>
<td>8,000</td>
<td>25</td>
<td>200,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$560,000</td>
</tr>
<tr>
<td>Inventory, 12/31/81</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product A</td>
<td>17,000</td>
<td>35</td>
<td>$595,000</td>
</tr>
<tr>
<td>Product B</td>
<td>9,000</td>
<td>28</td>
<td>252,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$847,000</td>
</tr>
<tr>
<td>Inventory, 12/31/82</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product A</td>
<td>13,000</td>
<td>40</td>
<td>$520,000</td>
</tr>
<tr>
<td>Product B</td>
<td>10,000</td>
<td>32</td>
<td>$320,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$840,000</td>
</tr>
</tbody>
</table>

Required:
1. Prepare a schedule to compute the internal conversion price indexes for 1981 and 1982. Round indexes to two decimal places.
2. Prepare a schedule to compute the inventory amounts at December 31, 1981 and 1982, using the dollar value LIFO inventory method.

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.

Account balances at January 1, 1984

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>1,200,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td>$263,100</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>900,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td>250,000</td>
</tr>
<tr>
<td>Automotive equipment</td>
<td>115,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></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.

E. Intangibles and Other Assets

1N85
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>Balance</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>
Selected Questions

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.

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>Description</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.
A. Preferred and Common Stock

Carr Corporation had the following stockholders' equity account balances at December 31, 1984:

<table>
<thead>
<tr>
<th>Account</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Additional paid-in capital from</td>
<td></td>
</tr>
<tr>
<td>preferred stock</td>
<td>90,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>5,150,000</td>
</tr>
<tr>
<td>Additional paid-in capital from</td>
<td></td>
</tr>
<tr>
<td>common stock</td>
<td>3,500,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Net unrealized loss on noncurrent</td>
<td></td>
</tr>
<tr>
<td>marketable equity securities</td>
<td>245,000</td>
</tr>
<tr>
<td>Treasury common stock</td>
<td>270,000</td>
</tr>
</tbody>
</table>

Transactions during 1985 and other information relating to the stockholders' equity accounts were as follows:

- Carr's preferred and common shares are traded on the over-the-counter market. At December 31, 1984, Carr had 100,000 authorized shares of $100 par, 10% cumulative preferred stock; and 3,000,000 authorized shares of no par common stock with a stated value of $5 per share.

- On January 10, 1985, Carr formally retired all 30,000 shares of its treasury common stock and had them revert to an unissued basis. The treasury stock had been acquired on January 20, 1984. The shares were originally issued at $10 per share.

- Carr owned 10,000 shares of Bush, Inc., common stock purchased in 1982 for $750,000. The Bush stock was included in Carr's short-term marketable securities portfolio. On February 15, 1985, Carr declared a dividend in kind of one share of Bush for every hundred shares of Carr common stock held by a stockholder of record on February 28, 1985. The market price of Bush common stock was $63 per share on February 15, 1985. The dividend in kind was distributed on March 12, 1985.

- On April 1, 1985, 250,000 stock rights were issued to the common stockholders permitting the purchase of one new share of common stock in exchange for one right and $11 cash. On April 25, 1985, 210,000 stock rights were exercised when the market price of Carr's common stock was $13 per share. Carr issued new shares to settle the transaction. The remaining 40,000 rights were not exercised and expired.

- On January 1, 1982, Carr granted stock options to employees for the purchase of 100,000 shares of the company's common stock at $8 per share which was also the market price. The options are exercisable within a three-year period beginning January 1, 1984. The measurement date is the same as the grant date. On July 1, 1985, employees exercised 80,000 options for $8 per share. On July 1, 1985, the market price of Carr's common stock was $15 per share. Carr used new shares to settle the transaction.


- After year-end adjustment the Net Unrealized Loss on Noncurrent Marketable Equity Securities account had a debit balance of $135,000 at December 31, 1985.

- On January 15, 1986, before the accounting records were closed for 1985, Carr became aware that rent income for the year ended December 31, 1984, was overstated by $500,000. The after tax effect on 1984 net income was $275,000. The appropriate correcting entry was recorded the same day.

- After correcting the rent income, net income for 1985 was $2,600,000.

Required:

a. Prepare Carr's statement of retained earnings for the year ended December 31, 1985. Assume that only single-period financial statements for 1985 are presented.

Selected Questions

2N84
Number 4

Number 4 consists of two unrelated parts.

Part b. Chee Corporation's post-closing trial balance at December 31, 1983, was as follows:

Chee Corporation
POST-CLOSING TRIAL BALANCE
December 31, 1983

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$ 290,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$ 550,000</td>
</tr>
<tr>
<td>Accumulated depreciation — building and equipment</td>
<td>200,000</td>
</tr>
<tr>
<td>Additional paid-in capital — common</td>
<td>1,560,000</td>
</tr>
<tr>
<td>In excess of par value from sale of treasury stock</td>
<td>250,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>30,000</td>
</tr>
<tr>
<td>Allowance to reduce long-term equity securities to market</td>
<td>25,000</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>400,000</td>
</tr>
<tr>
<td>Building and equipment</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Cash</td>
<td>220,000</td>
</tr>
<tr>
<td>Common stock ($1 par value)</td>
<td>150,000</td>
</tr>
<tr>
<td>Dividends payable on preferred stock — cash</td>
<td>4,000</td>
</tr>
</tbody>
</table>

At December 31, 1983, Chee had the following number of common and preferred shares:

<table>
<thead>
<tr>
<th>Common</th>
<th>Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized</td>
<td>500,000</td>
</tr>
<tr>
<td>Issued</td>
<td>150,000</td>
</tr>
<tr>
<td>Outstanding</td>
<td>140,000</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.

VII. Cost Accumulation, Planning, and Control

2N85
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 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:

<table>
<thead>
<tr>
<th>At the end of year</th>
<th>Amount</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

AP-179
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%.

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>Accounts receivable $100,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Inventories 90,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Plant and equipment 150,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Totals $340,000</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

Liabilities and Stockholders' Equity:

| Accounts payable — general creditors $600,000 | |
| Common stock outstanding 60,000 | |
| Deficit (320,000) | |
| Total $340,000 | |

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.
Selected Questions

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.

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 (000 omitted)</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.

AP-181
Accounting Practice

2M84
Number 5 (cont.)

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:

Beginning inventories — March 1
- Direct materials $ 20,000
- Work in process 40,000
- Finished goods 102,000

Purchases of direct materials during March 110,000
Ending inventories — March 31
- Direct materials 26,000
- Work in process
- Finished goods 105,000

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:

\[
\begin{array}{lcc}
\text{Input} & \text{Total} \\
\text{Direct materials} & 3 \text{ lbs. @ } $2.50 \text{ per lb.} & $7.50 \\
\text{Direct labor} & 5 \text{ hrs. @ } $7.50 \text{ per hr.} & 37.50 \\
\text{Factory overhead:} & & \\
\text{Variable} & $3.00 \text{ per direct labor hour} & 15.00 \\
\text{Fixed} & $4.00 \text{ per direct labor hour} & 20.00 \\
\text{Standard cost per unit} & & $80.00 \\
\end{array}
\]

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:

- Direct materials purchased 25,000 lbs. @ $2.60
- Direct materials used 23,100 lbs.
- Direct labor 40,100 hrs. @ $7.30
- Factory overhead $300,000

Required:
  a. Prepare a schedule of budgeted production costs for January 1984, based on actual production of 7,800 units.

AP-182
Selected Questions

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.

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.
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Selected Questions

VIII. Not-for-Profit and Governmental Accounting

2M87

Number 5 Estimated time — — 40 to 50 minutes)

Esperanza Hospital’s post-closing trial balance at December 31, 1986, appears on the tear-out worksheet on page 14.

Esperanza, which is a nonprofit hospital, did not maintain its books in conformity with the principles of hospital fund accounting. Effective January 1, 1987, Esperanza’s board of trustees voted to adjust the December 31, 1986 general ledger balances, and to establish separate funds for the general (unrestricted) funds, the endowment fund, and the plant replacement and expansion fund.

Additional account information:

- Investment in corporate bonds pertains to the amount required to be accumulated under a board policy to invest cash equal to accumulated depreciation until the funds are needed for asset replacement. The $500,000 balance at December 31, 1986, is less than the full amount required because of errors in computation of building depreciation for past years. Included in the allowance for depreciation is a correctly computed amount of $90,000 applicable to equipment.

- Endowment fund balance has been credited with the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Donor’s bequest of cash</td>
<td>$300,000</td>
</tr>
<tr>
<td>Gains on sales of securities</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest and dividends earned in 1984, 1985, and 1986</td>
<td>120,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$520,000</strong></td>
</tr>
</tbody>
</table>

The terms of the bequest specify that the principal, plus all gains on sales of investments, are to remain fully invested in U.S. government or corporate securities. At December 31, 1986, $400,000 was invested in U.S. Treasury bills. The bequest further specifies that interest and dividends earned on investments are to be used for payment of current operating expenses.

- Land comprises the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Donation of land in 1970, at appraised value</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Appreciation in fair value of land as determined</td>
<td></td>
</tr>
<tr>
<td>by independent appraiser in 1980</td>
<td>60,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>

- Building comprises the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hospital building completed in January 1947, when operations were started</td>
<td>$720,000</td>
</tr>
<tr>
<td>were started (estimated useful life 50 years), at cost</td>
<td></td>
</tr>
<tr>
<td>Installation of elevator in January 1967</td>
<td></td>
</tr>
<tr>
<td>(estimated useful life 20 years), at cost</td>
<td>80,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$800,000</strong></td>
</tr>
</tbody>
</table>

Required:

Turn to the tear-out worksheet on pages 14 and 15, and enter the adjustments necessary to restate the general ledger account balances properly. Distribute the adjusted balances to establish the separate fund accounts, and complete the worksheet. Formal journal entries are not required, but supporting computations should be referenced to the worksheet adjustments.
**Esperanza Hospital**

**WORKSHEET TO ADJUST GENERAL LEDGER BALANCES AND TO ESTABLISH SEPARATE FUNDS**

*January 1, 1987*

<table>
<thead>
<tr>
<th>Account</th>
<th>Trial Balance December 31, 1986</th>
<th>Adjustments</th>
<th>General (Unrestricted) Funds</th>
<th>Endowment Fund</th>
<th>Plant Replacement and Expansion Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debit Credit</td>
<td>Debit Credit</td>
<td>Debit Credit</td>
<td>Debit Credit</td>
<td>Debit Credit</td>
</tr>
<tr>
<td>Cash</td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in U.S. Treasury bills</td>
<td>400,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in corporate bonds</td>
<td>500,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest receivable</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>50,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>30,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>800,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>170,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowance for depreciation</td>
<td></td>
<td>410,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
<td>20,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td></td>
<td>70,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Endowment fund balance</td>
<td></td>
<td>520,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other fund balances</td>
<td></td>
<td>1,100,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Esperanza Hospital
WORKSHEET TO ADJUST GENERAL LEDGER BALANCES
AND TO ESTABLISH SEPARATE FUNDS
January 1, 1987

<table>
<thead>
<tr>
<th>Account</th>
<th>Trial Balance December 31, 1986</th>
<th>Adjustments</th>
<th>General (Unrestricted) Funds</th>
<th>Endowment Fund</th>
<th>Plant Replacement and Expansion Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
</tr>
</tbody>
</table>

Totals | 2,120,000 | 2,120,000 |
On January 2, 1985, Pine City's council officially approved a three-year special assessment project for a street-improvement program. Approval of this project was based on the following information:

- Issuance of $10,000,000 serial bonds at face amount, as follows:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Rate</th>
<th>Maturity Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,000,000</td>
<td>6%</td>
<td>December 31, 1985</td>
</tr>
<tr>
<td>3,000,000</td>
<td>7%</td>
<td>December 31, 1986</td>
</tr>
<tr>
<td>5,000,000</td>
<td>8%</td>
<td>December 31, 1987</td>
</tr>
</tbody>
</table>

- Interest expense on the serial bonds for 1985, 1986, and 1987 is estimated at $730,000, $610,000, and $400,000, respectively.

- Assessments of $9,000,000 will be levied, payable over a three-year period by property owners benefitting from the project, with $3,000,000 due on June 30, 1985, 1986, and 1987, respectively. Interest, to be charged at the simple rate of 10% on the deferred installments, from June 30, 1985, to the due dates, is expected to be as follows:

<table>
<thead>
<tr>
<th>Due Dates</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2, 1986</td>
<td>$300,000</td>
</tr>
<tr>
<td>June 30, 1986</td>
<td>300,000</td>
</tr>
<tr>
<td>January 2, 1987</td>
<td>150,000</td>
</tr>
<tr>
<td>June 30, 1987</td>
<td>150,000</td>
</tr>
</tbody>
</table>

- Signing of a construction contract for a fixed fee of $9,500,000, with the following payment schedule: $1,500,000 in advance on January 15, 1985; progress billing of $6,000,000 times the percentage of completion to be computed every November 30, payable on December 31; $2,000,000 on completion. Completion estimates are 30% at November 30, 1985, an additional 40% on November 30, 1986, and the final 30% on November 30, 1987.

- Investment of temporary funds in six-month certificates of deposit, at an estimated interest rate of 12.

- Interest revenue on the certificates of deposit for 1985, 1986, and 1987 is estimated at $900,000, $700,000, and $500,000, respectively.

- Project to be accounted for by integration of formal budgetary accounting entries and controlling accounts.

- Pine City maintains its records on a non-GAAP budgetary basis, in which bond proceeds are considered other financing sources, and principal repayments are considered expenditures and are appropriated. For revenue recognition purposes, Pine City considers revenues as "available" when the funds are collectible within 60 days of year-end.

During 1985, Pine City had the following transactions and adjustments relating to this street-improvement project:

1. January 2 — Adoption of annual operating budget.
3. January 2 — Issuance of serial bonds and receipt of $10,000,000 proceeds.
5. January 2 — Purchase of $8,000,000 certificate of deposit, due June 30, 1985, yielding interest of $480,000.
6. January 15 — Payment of $1,500,000 advance to contractor.
Selected Questions

7. June 30 — Collection of $3,000,000 on current portion of special assessments.
8. June 30 — Collection of $8,000,000 principal and $480,000 interest on certificate of deposit.
9. July 1 — Purchase of $11,000,000 certificate of deposit, due December 31, 1985, yielding interest of $500,000.
10. November 30 — Receipt of progress invoice from contractor for an additional payment of $2,100,000, indicating 35% completion.
11. December 31 — Collection of $11,000,000 principal and $500,000 interest on certificate of deposit.
12. December 31 — Payment of contractor’s November 30 progress invoice.
13. December 31 — Payment of $50,000 to contractor for removal of old street signs, erroneously omitted from contract.
14. December 31 — Payment of $2,000,000 matured serial bonds, plus interest.
15. December 31 — Adjusting entries for interest payable on serial bonds and interest receivable on special assessments.

Required:
In chronological order, prepare journal entries in the special assessment fund pertaining to the foregoing transactions and adjustments. Omit explanations and closing entries.

2M86
Number 5 (Estimated time — 40 to 50 minutes)

Listed below are four independent transactions or events that relate to a local government and to a voluntary health and welfare organization:

[1] $25,000 was disbursed from the general fund (or its equivalent) for the cash purchase of new equipment.
[2] An unrestricted cash gift of $100,000 was received from a donor.
[3] Listed common stocks with a total carrying value of $50,000, exclusive of any allowance, were sold by an endowment fund for $55,000, before any dividends were earned on these stocks. There are no restrictions on the gain.

[4] $1,000,000 face amount of general obligation bonds payable were sold at par, with the proceeds required to be used solely for construction of a new building. This building was completed at a total cost of $1,000,000, and the total amount of bond issue proceeds was disbursed in connection therewith. Disregard interest capitalization.

Required:
a. For each of the above-listed transactions or events, prepare journal entries, without explanations, specifying the affected funds and account groups, and showing how these transactions or events should be recorded by a local government whose debt is serviced by general tax revenues.
b. For each of the above-listed transactions or events, prepare journal entries, without explanations, specifying the affected funds, and showing how these transactions or events should be recorded by a voluntary health and welfare organization that maintains a separate plant fund.
Accounting Practice

2N85
Number 4 (Estimated time — 45 to 55 minutes)

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>Assets</th>
<th>1985</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<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</td>
<td>976,000</td>
<td>780,000</td>
</tr>
<tr>
<td>reimbursable grant 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</td>
<td>518,000</td>
<td>370,000</td>
</tr>
<tr>
<td>amortization</td>
<td></td>
<td></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>Liability and Fund Balances</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<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</td>
<td>596,000</td>
<td>546,000</td>
</tr>
<tr>
<td>equipment</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.

AP-190
Selected Questions

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>Unrestricted</th>
<th>Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>$188,000</td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td>188,000</td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>188,000</td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>188,000</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>188,000</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>960,000</td>
<td></td>
</tr>
<tr>
<td>Less amount representing interest</td>
<td>(166,000)</td>
<td></td>
</tr>
<tr>
<td>Present value of minimum lease payments</td>
<td>$794,000</td>
<td></td>
</tr>
</tbody>
</table>

Required:
Prepare the statement of changes in financial position, including the schedule of changes in working capital, for the year ended June 30, 1985.

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:

Community Association For Handicapped Children
ADJUSTED CURRENT FUNDS TRIAL BALANCES
June 30, 1984

<table>
<thead>
<tr>
<th></th>
<th>Unrestricted</th>
<th>Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$40,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>Bequest receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pledges receivable</td>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Investments (at cost, which approximates market)</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>$50,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for uncollectible pledges</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Fund balances, July 1, 1983:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Designated</td>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td>Undesignated</td>
<td>26,000</td>
<td></td>
</tr>
<tr>
<td>Restricted</td>
<td></td>
<td>3,000</td>
</tr>
</tbody>
</table>

AP-191
**Accounting Practice**

2M85
Number 5 (cont.)

<table>
<thead>
<tr>
<th>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfers of endowment fund income</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>300,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Membership dues</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Program service fees</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Deaf children’s program</td>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td>Blind children’s program</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Management and general services</td>
<td>45,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Fund-raising services</td>
<td>8,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Provision for uncollectible pledges</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$478,000</strong></td>
<td><strong>$478,000</strong></td>
</tr>
<tr>
<td><strong>Change in fund balances</strong></td>
<td><strong>$19,000</strong></td>
<td><strong>$19,000</strong></td>
</tr>
</tbody>
</table>

**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>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$62,000</td>
<td></td>
</tr>
<tr>
<td>Taxes receivable — delinquent</td>
<td>46,000</td>
<td></td>
</tr>
<tr>
<td>Estimated uncollectible taxes — delinquent</td>
<td></td>
<td>$8,000</td>
</tr>
<tr>
<td>Stores inventory — program operations</td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>28,000</td>
<td></td>
</tr>
<tr>
<td>Fund balance reserved for stores inventory</td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td>Fund balance reserved for encumbrances</td>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td>Unreserved undesignated fund balance</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<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

   **Total** $600,000

AP-192
Selected Questions

Expenditures and other financing uses

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program operations</td>
<td>300,000</td>
</tr>
<tr>
<td>General administration</td>
<td>120,000</td>
</tr>
<tr>
<td>Stores — program operations</td>
<td>60,000</td>
</tr>
<tr>
<td>Capital outlay</td>
<td>80,000</td>
</tr>
<tr>
<td>Periodic transfer to special assessment fund</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>580,000</strong></td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program operations</td>
<td>176,000</td>
</tr>
<tr>
<td>General administration</td>
<td>80,000</td>
</tr>
<tr>
<td>Capital outlay</td>
<td>60,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>316,000</strong></td>
</tr>
</tbody>
</table>

4. The city council designated $20,000 of the unreserved undesignated fund balance for possible future appropriation for capital outlay.

5. Cash collections and transfer:

<table>
<thead>
<tr>
<th></th>
<th>$</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><strong>Total</strong></td>
<td><strong>664,000</strong></td>
</tr>
</tbody>
</table>

6. Cancelled encumbrances:

<table>
<thead>
<tr>
<th></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></th>
<th>$</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.

---

A partial balance sheet of Rapapo State University as of the end of its fiscal year ended July 31, 1982, is presented below.

**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><strong>Unrestricted:</strong></td>
<td><strong>Unrestricted:</strong></td>
</tr>
<tr>
<td>Cash</td>
<td>Accounts payable</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td>Accounts receivable—</td>
<td>Due to other funds</td>
</tr>
<tr>
<td>tuition and fees, less allowance</td>
<td>40,000</td>
</tr>
<tr>
<td>for doubtful accounts of $15,000</td>
<td></td>
</tr>
<tr>
<td>360,000</td>
<td>Deferred revenue—tuition and fees</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>Fund balance</td>
</tr>
<tr>
<td>40,000</td>
<td>435,000</td>
</tr>
<tr>
<td><strong>Total unrestricted</strong></td>
<td><strong>Total unrestricted</strong></td>
</tr>
<tr>
<td>600,000</td>
<td>600,000</td>
</tr>
<tr>
<td></td>
<td><strong>Restricted:</strong></td>
</tr>
<tr>
<td>Cash</td>
<td>Accounts payable</td>
</tr>
<tr>
<td>10,000</td>
<td>Fund balance</td>
</tr>
<tr>
<td>Investments</td>
<td>215,000</td>
</tr>
<tr>
<td><strong>Total restricted</strong></td>
<td><strong>Total restricted</strong></td>
</tr>
<tr>
<td>220,000</td>
<td>220,000</td>
</tr>
<tr>
<td><strong>Total current funds</strong></td>
<td><strong>Total current funds</strong></td>
</tr>
<tr>
<td>$820,000</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.
Selected Questions

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>
<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:

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**Accounting Practice**

**2M83**

Number 5 (cont.)

<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.

---

**IX. Federal Taxation — Individuals, Estates, and Trusts**

**2M87**

Number 4 (Estimated time — — 45 to 55 minutes)

In December 1986, John Ford (age 40) died, leaving a wife (Ann, age 35) and a dependent son (Earl, age 3). A 1986 joint return was filed in April 1987 for John and Ann. Ann now consults you, as a CPA, for advice as to how the 1986 Tax Reform Act is expected to affect her 1987 tax status. She furnishes you with the following projections pertaining to her expected cash receipts and expenditures for the year ending December 31, 1987:

**Employment as an outside salesperson:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross salary and commissions</td>
<td>$50,000</td>
</tr>
<tr>
<td>Ordinary and necessary employee business expenses</td>
<td></td>
</tr>
<tr>
<td>Allowable transportation</td>
<td>4,000</td>
</tr>
<tr>
<td>Stationery, postage, telephone</td>
<td>1,000</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td></td>
</tr>
<tr>
<td>Federal income tax withheld</td>
<td>9,000</td>
</tr>
<tr>
<td>FICA tax withheld</td>
<td>3,132</td>
</tr>
<tr>
<td>State income tax withheld</td>
<td>1,800</td>
</tr>
</tbody>
</table>

AP-196
Selected Questions

Employment as part-time teacher:
Gross salary 3,000
Payroll taxes
Federal income tax withheld 300
FICA tax withheld 215

Other cash expected to be received in 1987:
Bequest under husband’s will 25,000
Life insurance proceeds on husband’s death 15,000
Dividends from taxable domestic corporations 500
Gross lottery winnings in January 1987 2,000

Security transaction in 1987:
Net proceeds from sale of 500 shares of stock 10,000
(This stock was inherited from Ann’s father, Sam, in 1980; Sam had paid $2,500 for this stock, which had a fair market value of $6,000 on the date of Sam’s death; Sam’s estate did not elect to use the alternate valuation date.)

In addition, John had provided in his will for the establishment of a simple trust, under which all of the trust’s income was required to be distributed currently to Ann, as beneficiary of this trust. The entire trust principal was invested in bank certificates of deposit. Trust income is expected to be $12,000 in 1987. However, Ann wants to draw only $7,000 of this income in 1987.

During 1987, Ann expects to have the following cash expenditures in addition to those indicated previously:

Food, clothing, household, and miscellaneous personal expenses for both Ann and Earl $20,000
Estimated income tax — federal 5,000
Estimated income tax — state 1,200
State inheritance tax on John’s taxable estate 2,100
Realty taxes on residence 3,600
City and state sales taxes 1,100
Auto license and registration fees 50
Contribution to church 600
Political contribution 100
Lottery tickets 420
Pari-mutuel gambling 480

Required:

a. Prepare a schedule listing all items of projected receipts and expenditures that have no effect on Ann Ford’s 1987 federal taxable income.

b. Prepare a schedule computing Ann Ford’s projected 1987 federal taxable income, in the following sequence:

Adjusted gross income
Itemized deductions
Personal exemptions ($1,900 per exemption)
Taxable income

c. Assume that Ann Ford’s projected 1987 federal income tax on her federal taxable income will be $12,421 before credits and prepayments of tax. Compute the projected balance of tax payable or net overpayment.

AP-197
The following information pertains to Alex and Myra Cole, a married couple filing a joint federal income tax return for the calendar year 1985:

**Alex, age 72 — cash received in 1985**

Social security benefits
- Gross amount $9,900
- Less voluntary premiums under Medicare Part B 190
- Net amount received 9,710

Proceeds of life insurance policy on death of friend 5,000

Proceeds from sales of stock
- Bought in May 1980 — basis $2,000 3,000
- Bought in October 1985 — basis $900 700

Dividends
- From taxable domestic corporations 500
- On life insurance policy (accumulated net premiums not exceeded) 131

**Myra, age 60 — cash received in 1985**

Salary — employed as actuary
- Gross amount $62,000
- Amounts withheld
  - Federal income tax $10,000
  - State income tax 3,349
  - FICA taxes 2,792
  - United Fund pledge 240
- Total cash received 45,619

**Cash paid in 1985**

Rent, household, and other personal expenses $40,000

Estimated 1985 federal income tax 3,000

Business travel away from home overnight 800

Continuing professional education courses required by Society of Actuaries 400

Medical and dental expenses
- Doctors $3,000
- Dentures 800
- Travel to doctors 3,900
- Total cash paid 500

Total cash paid $48,600
Selected Questions

Additional information:

- The 1984 joint federal income tax return showed a tax overpayment of $900, which was refunded to the Coles in 1985.
- The 1984 joint state income tax return showed a tax overpayment of $110, which was refunded to the Coles in 1985.
- The Coles itemized their deductions on their 1984 return.
- In March 1985, Alex donated 100 shares of stock of a listed corporation to a recognized charitable organization. Alex’s basis for this stock, which was bought in 1960, was $1,000. Fair market value of this stock on the date of the donation was $7,000.
- Included in the Coles’ personal expenses was $1,100 for state sales taxes, substantiated by receipts. The Coles elected not to use the optional state sales tax table.
- The Coles supported their son, Ben, who had been disabled since birth, and who lived in the Cole household. Ben had no income. He died in January 1985 at the age of 34.
- In June 1985, Myra received a watch as a gift from her employer, as a token of the employer’s appreciation for Myra’s efforts in recruiting new clients. This watch had a fair market value of $1,500. The recruiting of new clients was not part of Myra’s prescribed duties.
- In 1980, Alex established a reversionary (“Clifford”) trust for the benefit of a destitute friend who lives alone. Trust income amounted to $2,200 in 1985, which constituted more than 50% of the friend’s support for the year. A local bank is trustee.
- Personal exemptions and exemptions for dependents are $1,040 each.
- The zero bracket amount is $3,540.

Required:

a. Prepare a detailed schedule computing Alex and Myra Cole’s joint taxable income for 1985. Show each appropriate item separately in the schedule, and classify each item properly. Any possible alternative treatment should be resolved in a manner that will minimize 1985 taxable income.

b. Assume that Alex and Myra Cole’s 1985 federal income tax on their 1985 joint taxable income is $12,957 before tax credits and payments. Compute the net amount of tax payable or net overpayment of tax.
Accounting Practice

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

2M86
Number 4 (Estimated time — 45 to 55 minutes)

The following adjusted revenue and expense accounts appeared in the accounting records of Wolf, Inc., an accrual basis taxpayer, for the year ended December 31, 1985:

**Revenues**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Equity in earnings of F &amp; W Partnership</td>
<td>60,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>8,000</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
</tr>
<tr>
<td>Gains on sale of stock</td>
<td>5,000</td>
</tr>
<tr>
<td>Key-man life insurance proceeds</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,191,000</strong></td>
</tr>
</tbody>
</table>

**Costs and expenses**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>500,000</td>
</tr>
<tr>
<td>Doubtful accounts</td>
<td>13,000</td>
</tr>
<tr>
<td>Taxes, other than federal income</td>
<td>62,000</td>
</tr>
<tr>
<td>Interest</td>
<td>12,000</td>
</tr>
<tr>
<td>Contributions</td>
<td>50,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>60,000</td>
</tr>
<tr>
<td>Other</td>
<td>40,000</td>
</tr>
<tr>
<td>Federal income taxes</td>
<td>120,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,857,000</strong></td>
</tr>
</tbody>
</table>

| **Net income**                                   | **$334,000**|

The following additional information is provided:

[1] Trade accounts receivable at December 31, 1984, and at December 31, 1985, amounted to $200,000 and $250,000, respectively.

[2] Wolf, Inc. owns 60% of F & W Partnership. The other 40% of F & W is owned by an unrelated individual. F & W reported the following tax information to Wolf, Inc.:

Wolf, Inc.'s share of:

- Partnership ordinary income: $58,000
- Dividends qualifying for exclusion: 10,000
- Net long-term capital gain (loss): ($8,000)
- Equity in earnings: $60,000

The $10,000 dividends were from an unrelated domestic corporation, Jel Corp., whose securities are traded on a major stock exchange.
Wolf, Inc.

**WORKSHEET TO CONVERT BOOK INCOME TO TAXABLE INCOME**

*For the Year Ended December 31, 1985*

<table>
<thead>
<tr>
<th>Revenues</th>
<th>Per books and GAAP</th>
<th>Increases</th>
<th>Decreases</th>
<th>Per tax return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>3,000,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity in earnings of F &amp; W Partnership</td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>8,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gains on sale of stock</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Key-man life insurance proceeds</td>
<td>100,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>3,191,000</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Costs and expenses</th>
<th>Per books and GAAP</th>
<th>Increases</th>
<th>Decreases</th>
<th>Per tax return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>2,000,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>500,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Doubtful accounts</td>
<td>13,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes, other than federal income</td>
<td>62,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>12,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>50,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>40,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal income taxes</td>
<td>120,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>2,857,000</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>334,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The $8,000 dividends were from Meg, Inc., an unrelated taxable domestic corporation, whose securities are traded on a major stock exchange.

Interest revenue consists of interest on:

<table>
<thead>
<tr>
<th>Type of Bond</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate bonds</td>
<td>$15,000</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>3,000</td>
</tr>
</tbody>
</table>

Gains on sale of stock consist of stock of the following unrelated corporations:

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ral Corp. (bought in May 1985; sold in June 1985)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Blu, Inc. (bought in November 1984; sold in September 1985)</td>
<td>4,000</td>
</tr>
</tbody>
</table>

Wolf, Inc. owned the key-man life insurance policy, paid the premiums, and was the direct beneficiary. The proceeds were collected on the death of the corporation’s treasurer.

Accounts payable for merchandise at December 31, 1984, and at December 31, 1985, amounted to $75,000 and $100,000, respectively.

Doubtful accounts expense represents a reasonable addition to Wolf, Inc.’s allowance for doubtful accounts, under the method consistently used. Actual accounts written off in 1985 amounted to $4,000.

Taxes, other than federal income, consist of:

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll taxes</td>
<td>$40,000</td>
</tr>
<tr>
<td>Property taxes</td>
<td>20,000</td>
</tr>
<tr>
<td>Penalty for late payment of taxes</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Interest expense consists of: $11,000 interest on funds borrowed for working capital, and $1,000 interest on funds borrowed to buy the municipal bonds.

Contributions were all paid in 1985 to State University, specifically designated for the purchase of laboratory equipment.

Depreciation per books is straight-line. For tax purposes, depreciation amounted to $85,000. The investment tax credit amounted to $3,000.

Other expenses include premiums of $5,000 on the key-man life insurance policy covering the treasurer, who died in December 1985.

Federal income tax paid in 1985 amounted to $105,000. The difference between the income tax provision and income tax paid is the result of interperiod tax allocation.

**Required:**

Complete the tear-out worksheet by making the necessary adjustments to convert Wolf, Inc.’s 1985 book income to federal taxable income.

Any possible alternative treatment should be resolved in a manner that will minimize 1985 taxable income for Wolf, Inc.
PROBLEMS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M87
Answer 5 (10 points)

a. Computation of Cox's Goodwill
   Implicit in the Terms of the
   Common Stock Issuance

   Cash paid by Rice for 1,000 shares $ 86,000

   Contribution by Cox
   Current fair value of assets
      Cash $ 16,500
      Accounts receivable 20,200
      Merchandise inventory 45,000
      Prepaid insurance 1,900
      Equipment 40,000
   _______________________
   123,600

   Current fair value of liabilities assumed
      Accounts payable 30,500
      Note payable 10,000
      Loan payable, delivery van 3,500
      Interest payable 600
      Payroll taxes withheld and accrued 2,100
   _______________________
   46,700

   Net contribution by Cox for 1,000 shares 76,900

   Cox's goodwill $ 9,100

b. Cox Stationers, Inc.
   BALANCE SHEET
   January 1, 1987

   Assets
   Current Assets:
      Cash $102,500
      Accounts $23,500
      Less allowance for doubtful accounts 20,200
      Merchandise inventory 45,000
      Prepaid insurance 1,900
   Total current assets 169,600
      Equipment 40,000
      Goodwill 9,100
   Total assets $218,700
Liabilities and Stockholders' Equity

Current Liabilities

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable, bank</td>
<td>$10,000</td>
</tr>
<tr>
<td>Loan payable, delivery van</td>
<td>3,500</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>30,500</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>600 [3]</td>
</tr>
<tr>
<td>Payroll taxes withheld and accrued</td>
<td>2,100</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td><strong>46,700</strong></td>
</tr>
</tbody>
</table>

Stockholders' Equity:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $50 par;</td>
<td></td>
</tr>
<tr>
<td>authorized 7,500 shares; issued</td>
<td>100,000</td>
</tr>
<tr>
<td>and outstanding 2,000 shares</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>72,000 [4]</td>
</tr>
<tr>
<td><strong>Total stockholders' equity</strong></td>
<td><strong>172,000</strong></td>
</tr>
</tbody>
</table>

Total liabilities and stockholders' equity

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total liabilities and stockholders' equity</strong></td>
<td><strong>$218,700</strong></td>
</tr>
</tbody>
</table>

Explanations of Amounts:

[1] Cash
   Balance, 12/31/86                                  | $16,500  |
   1/1/87, sale of common stock to Rice               | 86,000   |
   **Balance, 1/1/87**                                | **$102,500**|

[2] Prepaid insurance
   Paid, 7/1/86                                       | $3,800   |
   **Prepaid, 12/31/86 (× ½)**                        | **$1,900**|

[3] Accrued interest on note payable
   Annual interest ($10,000 × 12%)                   | $1,200   |
   July 1 — December 31, 1986 (× ½)                  | $600     |

   Total assets                                       | **$218,700**|
   Deduct liabilities                                | 46,700   |
   **Total stockholders' equity**                    | **172,000**|
   Deduct common stock (2,000 shares × $50)          | 100,000  |
   Additional paid-in capital                         | $72,000  |
**Unofficial Answers**

_1M86_

**Answer 5 (10 points)**

**Rand, Inc.**

**WORKSHEET FOR BALANCE SHEET**

**AND INCOME STATEMENT**

**December 31, 1985**

<table>
<thead>
<tr>
<th>Balance sheet</th>
<th>Adjustments</th>
<th>Corrected balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance per books</strong></td>
<td><strong>Dr. (Cr.)</strong></td>
<td><strong>Debit</strong></td>
</tr>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$275,000</td>
<td></td>
</tr>
<tr>
<td>Marketable securities, at cost</td>
<td>78,000</td>
<td></td>
</tr>
<tr>
<td>Allowance to reduce marketable securities to market</td>
<td>—</td>
<td>[1] $11,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>487,000</td>
<td>[2] $15,800</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(50,000)</td>
<td></td>
</tr>
<tr>
<td>Property and equipment</td>
<td>310,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(150,000)</td>
<td>[5] 21,000</td>
</tr>
<tr>
<td><strong>Total assets:</strong></td>
<td>$1,375,000</td>
<td>$66,800</td>
</tr>
</tbody>
</table>

| Liabilities & stockholders' equity: | | | | |
| Accounts payable & accrued liabilities | $420,000 | | | $420,000 |
| Estimated liability from lawsuit | 100,000 | [7] $100,000 | | — |
| Common stock | 260,000 | | | 260,000 |
| Additional paid-in capital | 130,000 | | | 130,000 |
| Retained earnings | | | | |
| Balance, 1/1/85 | 254,000 | [3] 12,000 | [4] $24,000 | 291,000 |
| **Total liabilities & stockholders' equity:** | $1,375,000 | $159,500 | $167,300 | $1,382,800 |

**Income statement**

| **Dr. (Cr.)** | | **Dr. (Cr.)** |
| Net sales | $(1,580,000) | $(1,580,000) |
| Cost of sales | 755,000 | [3] $5,500 | 760,500 |
| Depreciation expense | 29,000 | [4] 6,000 | | 35,000 |
| Other income | | | [5] 2,500 | (2,500) |
| Unrealized loss on marketable securities | | [1] 11,000 | | 11,000 |
| Estimated loss from lawsuit | 100,000 | | [7] 100,000 | — |
| Net income | $(211,000) | $47,500 | $118,300 | $(281,800) |

AP-205
Explanations of Corrections

[1] Decline in market valuation of marketable securities at 12/31/85
   - At cost
   - Market valuation
   - Unrealized loss on marketable securities [Dr.]
   - Allowance to reduce marketable securities to market [Cr.]

   $78,000
   $67,000
   $11,000
   $11,000

[2] Decline in doubtful accounts expense rate effective 1/1/85
   - Doubtful accounts expense charge at 3% of net sales
     for 1985 [3% × $1,580,000]
   - Doubtful accounts expense stated at 2% of net sales
     for 1985 [2% × $1,580,000]
   - Allowance for doubtful accounts [Dr.]
   - Selling & adm. expense — Doubtful accounts expense [Cr.]

   $47,400
   $31,600
   $15,800
   $15,800

[3] Inventories overstated at 12/31/84 and 12/31/85
   - Retained earnings [overstatement at 12/31/84] [Dr.]
   - Cost of sales for 1985 [$17,500 – $12,000] [Dr.]
   - Inventories [overstatement at 12/31/85] [Cr.]

   $12,000
   $5,500
   $17,500

[4] Incorrect recording of equipment purchased 1/1/84
   - Property and equipment [Dr.]
   - Depreciation expense — 1985 [20% × $30,000] [Dr.]
   - Accumulated depreciation [2 × $6,000] [Cr.]
   - Retained earnings (understatement at 12/31/84) [$30,000 – $6,000] [Cr.]

   $30,000
   $6,000
   $12,000
   $24,000
   $36,000

[5] Incorrect recording of fully depreciated equipment sold as scrap 7/1/85
   - Accumulated depreciation [Dr.]
   - Property and equipment [$21,000 – $2,500] [Cr.]
   - Other income [Cr.]

   $21,000
   $18,500
   $2,500

[6] Incorrect recording of sales catalogs as expense in 1984
   - Selling & adm. exp. — Advertising & promotion [Dr.]
   - Retained earnings (understatement at 12/31/84) [Cr.]

   $25,000
   $25,000

[7] Reversal of liability from lawsuit — No probable loss 12/31/85
   - Estimated liability from lawsuit [Dr.]
   - Estimated loss from lawsuit [Cr.]

   $100,000
   $100,000
Ward Specialty Foods

WORKSHEET TO CONVERT

TRIAL BALANCE TO ACCRUAL BASIS

December 31, 1983

<table>
<thead>
<tr>
<th>Cash basis</th>
<th>Adjustments</th>
<th>Accrual basis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dr.</strong></td>
<td><strong>Cr.</strong></td>
<td><strong>Dr.</strong></td>
</tr>
<tr>
<td>Cash</td>
<td>18,500</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4,500</td>
<td>[1] 3,400</td>
</tr>
<tr>
<td>Allow. for doubtful accts.</td>
<td></td>
<td>[2] 1,100</td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td>[3] 3,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td>Acc. deprec.</td>
<td>$ 9,000</td>
<td></td>
</tr>
<tr>
<td>Prepaid rent</td>
<td></td>
<td>[4] 6,300</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td></td>
<td>[5] 600</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>4,800</td>
<td>[7] 4,000</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>[8] 1,360</td>
<td></td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>850</td>
<td></td>
</tr>
<tr>
<td>Ward, drawings</td>
<td>24,000</td>
<td></td>
</tr>
<tr>
<td>Ward, capital</td>
<td>33,650</td>
<td>[8] 900</td>
</tr>
</tbody>
</table>

Sales | 187,000 | [1] 3,400 | 190,400 |

Purchases | 82,700 | [7] 4,000 | 86,700 |

Income summary | 20,000 | [3] 23,000 | 3,000 |

Salaries | 29,500 | [8] 135 | 29,635 |

Payroll taxes | 2,900 | [8] 150 | 3,050 |

Rent | 8,400 | [4] 675 | 7,725 |


Insurance | 2,400 | [8] 175 | 3,675 |

Utilities | 3,500 | [6] 5,800 | 5,800 |

Depreciation |        | [2] 1,100 | 1,100 |

Doubtful accounts exp. | | |

$235,300 $235,300 $45,560 $45,560 $259,225 $259,225

Explanations of Adjustments

[1] To convert 1983 sales to accrual basis

[2] To record provision for doubtful accounts

[3] To record increase in inventory from 12/31/82 to 12/31/83

Accounts receivable, 12/31/83 | $ 7,900 | Inventory, 12/31/83 | $23,000 |

Deduct accounts receivable, 12/31/82 | 4,500 | Inventory, 12/31/82 | 20,000 |

Increase in sales | $ 3,400 | Increase | $ 3,000 |
b. Ward Specialty Foods

STATEMENT OF CHANGES IN
MARY WARD, CAPITAL
For the Year Ended December 31, 1983

Mary Ward, capital, 12/31/82 $38,915 [1]
Add net income for year 49,475 [2]
Deduct drawings for year 24,000
Mary Ward, capital, 12/31/83 $64,390

Explanations of Amounts

[1] Mary Ward, capital, 12/31/82 after adjustment to accrual basis (per worksheet).

[2] Computation of net income on accrual basis for the year ended 12/31/83 (per worksheet)

Payroll taxes $ 400 - $250 $150
Salaries $ 510 - $375 135
Utilities $ 450 - $275 175
$1,360 $900

Bryant Corporation

WORKSHEET FOR BALANCE SHEET
AND STATEMENT OF INCOME
November 30, 1982

<table>
<thead>
<tr>
<th>Unadjusted balance</th>
<th>Adjustments</th>
<th>Adjusted balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Marketable securities, at cost</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Allowance for reduction to market</td>
<td></td>
<td>[1] 5,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>450,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(59,000)</td>
<td>[2] 23,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>430,000</td>
<td>[3] 12,000</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>15,000</td>
<td>[4] 3,000</td>
</tr>
<tr>
<td>Property, plant &amp; equipment</td>
<td>426,000</td>
<td>[6] 24,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(40,000)</td>
<td>[6] 2,400</td>
</tr>
<tr>
<td>Research &amp; development costs</td>
<td>120,000</td>
<td>[7] 120,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,552,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

AP-208
Unofficial Answers

Liabilities & stockholders’ equity

| Accounts payable & accrued expenses | $ (592,000) | [5] 22,500 | (614,500) |
| Estimated liability from lawsuit | [8] 50,000 | (50,000) |
| Income taxes payable | (224,000) | [9] 55,160 | (168,840) |
| Common stock | (400,000) | (400,000) |
| Retained earnings | (336,000) | [x] 82,740 | (253,260) |

$1,552,000 $1,486,600

Statement of Income

| Net sales | $(2,950,000) | $(2,950,000) |
| Cost of sales | 1,670,000 | [3] 12,000 | 1,634,000 |
| Selling & administrative expenses | 650,000 | [5] 22,500 | 646,500 |
| Depreciation expense | 40,000 | [6] 2,400 | 42,400 |
| Research & development expense | 30,000 | [7] 120,000 | 150,000 |
| Unrealized loss on marketable securities | [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) |

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></td>
<td>Allowance to reduce marketable securities to market</td>
</tr>
<tr>
<td></td>
<td>To reduce short-term investments to market valuation ($60,000 – $55,000)</td>
</tr>
<tr>
<td>(2) Allowance for doubtful accounts</td>
<td>23,000</td>
</tr>
<tr>
<td></td>
<td>Selling and administrative expenses (bad debts)</td>
</tr>
<tr>
<td></td>
<td>To reduce allowance account to balance determined by aging of receivables ($59,000 – $36,000)</td>
</tr>
<tr>
<td>(3) Inventories</td>
<td>12,000</td>
</tr>
<tr>
<td></td>
<td>Cost of sales</td>
</tr>
<tr>
<td></td>
<td>To adjust for work-in-process inventory held by outside processor</td>
</tr>
<tr>
<td>(4) Prepaid insurance</td>
<td>3,000</td>
</tr>
<tr>
<td></td>
<td>Selling and administrative expenses (insurance)</td>
</tr>
<tr>
<td></td>
<td>To adjust for nonrecognition of prepaid expense</td>
</tr>
<tr>
<td>(5) Selling and administrative expenses (pension)</td>
<td>22,500</td>
</tr>
<tr>
<td></td>
<td>Accounts payable and accrued expenses</td>
</tr>
<tr>
<td></td>
<td>To accrue normal pension cost (45,000 x 6/12)</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></td>
<td>Cost of sales (repairs &amp; maintenance)</td>
</tr>
<tr>
<td></td>
<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>
</tr>
</tbody>
</table>

AP-209
Accounting Practice

Answer 5 (cont.)

(7) Research and development expense  
   Research and development costs  
To write off research and development costs in accordance with GAAP

(8) Estimated loss from lawsuit  
   Estimated liability from lawsuit  
To record probable damages payable re: lawsuit for patent infringement

(9) Income taxes payable  
   Provision for income taxes  
To adjust provision for year ended 11/30/82 (Schedule 1)

Schedule 1
Adjustment to Income Tax Provision—Year Ended November 30, 1982

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  62,000
Decuct 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  199,900
Adjusted income before income taxes  422,100
Effective income tax rate  × 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

1N86
Answer 5 (10 points)

Garr Corporation
INCOME STATEMENT
For the Year Ended December 31, 1985

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$10,750,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>5,920,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>4,830,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>2,600,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>2,230,000</td>
</tr>
<tr>
<td>Other income</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>65,000</td>
</tr>
<tr>
<td>Income before unusual item and income tax</td>
<td>2,295,000</td>
</tr>
<tr>
<td>Unusual item</td>
<td></td>
</tr>
<tr>
<td>Gain on litigation settlement</td>
<td>200,000</td>
</tr>
<tr>
<td>Income from continuing operations before income tax</td>
<td>2,495,000</td>
</tr>
<tr>
<td>Income tax</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$928,000 [3]</td>
</tr>
<tr>
<td>Deferred</td>
<td>70,000 [2]</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>1,497,000</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td></td>
</tr>
<tr>
<td>Operating loss from discontinued</td>
<td>(66,000) [4]</td>
</tr>
<tr>
<td>Plastics Division (less applicable income tax saving of $44,000)</td>
<td></td>
</tr>
<tr>
<td>Gain on disposal of Plastics Division</td>
<td>90,000 [5]</td>
</tr>
<tr>
<td>(less applicable income tax of $60,000)</td>
<td>24,000</td>
</tr>
<tr>
<td>Income before cumulative effect of a change</td>
<td>1,521,000</td>
</tr>
<tr>
<td>in accounting principle</td>
<td></td>
</tr>
<tr>
<td>Cumulative effect on prior years of changing to a different depreciation method (less applicable deferred income tax of $140,000)</td>
<td>(210,000) [6]</td>
</tr>
<tr>
<td>Net income</td>
<td>$1,311,000</td>
</tr>
<tr>
<td>Earnings per share</td>
<td></td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>$6.51 [7]</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>0.10 [8]</td>
</tr>
<tr>
<td>Cumulative effect on prior years of changing to a different depreciation method</td>
<td>(0.91) [9]</td>
</tr>
<tr>
<td>Net income</td>
<td>$5.70 [10]</td>
</tr>
</tbody>
</table>

Explanations of Amounts:

   Income from continuing operations before income tax $2,495,000
   Income tax rate × 40%
   Income tax excluding discontinued operations and cumulative effect of accounting change $ 998,000
   Depreciation per tax return $750,000
   Less depreciation per books 575,000
   Timing difference 175,000
   Income tax rate \times 40% 70,000
   Deferred income tax $70,000

[3] Current income tax for 1985 excluding discontinued operations
   and cumulative effect of accounting change
   Income tax excluding discontinued operations $998,000
   Less deferred income tax 70,000
   Current income tax $928,000

[4] Discontinued operations — Operating loss from Plastics Division
   Sales $2,200,000
   Cost of sales 1,650,000
   Selling and administrative expenses 660,000
   Loss (110,000)
   Income tax saving (40\% \times $110,000) 44,000
   Net of income tax $66,000

[5] Discontinued operations — Gain on disposal of Plastics Division
   Gain on disposal $150,000
   Income tax (40\% \times $150,000) 60,000
   Net of income tax $90,000

[6] Cumulative effect of changing to a different depreciation method
   Depreciation adjustment — accounting change $350,000
   Reduction in deferred income tax ($350,000 \times 40\%) 140,000
   Net of income tax $210,000

[7] Earnings per share — Income from continuing operations
   Income from continuing operations $1,497,000
   Weighted average number of shares outstanding for 1985 (200,000 + 30,000) 230,000
   Earnings per share ($1,497,000 \div 230,000) $6.51

[8] Earnings per share — Discontinued operations
   Discontinued operations $24,000
   Weighted average number of shares 230,000
   Earnings per share ($24,000 \div 230,000) $0.10

[9] Earnings per share — Cumulative effect on prior years
   of changing to a different depreciation method
   Cumulative effect $210,000
   Weighted average number of shares 230,000
   Earnings per share $(0.91)
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Earnings per share</strong> — Net income</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$1,311,000</td>
</tr>
<tr>
<td>Weighted average number of shares</td>
<td>230,000</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>$5.70</td>
</tr>
</tbody>
</table>

**1M85**  
Answer 5 (10 points)

**Glenn Corporation**  
**INCOME STATEMENT**  
*For the Year Ended December 31, 1984*

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$12,500,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>7,500,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>2,425,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>2,575,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>245,000</td>
</tr>
<tr>
<td>Income before unusual or infrequent items and income tax</td>
<td>2,330,000</td>
</tr>
<tr>
<td><strong>Unusual or infrequent items</strong></td>
<td></td>
</tr>
<tr>
<td>Loss on litigation settlement</td>
<td>$(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>1,210,000</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>912,000 [1]</td>
</tr>
<tr>
<td><strong>Extraordinary item — loss due to earthquake</strong></td>
<td></td>
</tr>
<tr>
<td>(net of applicable income tax saving of $380,000)</td>
<td>570,000 [4]</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$658,000</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings per share</td>
<td></td>
</tr>
<tr>
<td>Income before ordinary item</td>
<td>$5.23 [5]</td>
</tr>
<tr>
<td>Extraordinary loss</td>
<td>(2.43) *</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$2.80 [6]</td>
</tr>
</tbody>
</table>

*Optional

**Glenn Corporation**  
**RECONCILIATION OF NET INCOME TO TAXABLE INCOME PER TAX RETURN**  
*For the Year Ended December 31, 1984*

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></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></td>
<td>140,000</td>
</tr>
<tr>
<td><strong>Total</strong></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><strong>Total</strong></td>
<td>560,000</td>
</tr>
<tr>
<td>Taxable income per tax return</td>
<td>$1,150,000</td>
</tr>
</tbody>
</table>
Explanations of Amounts

[1] Total income tax excluding extraordinary item for 1984
   Income before income tax and extraordinary item
   Add permanent difference — premiums on officers' life insurance
   Income subject to tax
   Income tax rate
   Income tax excluding extraordinary item

   Depreciation per tax return
   Less depreciation per books
   Timing difference
   Income tax rate
   Deferred income tax

[3] Current income tax excluding extraordinary item for 1984
   Income tax excluding extraordinary item for 1984
   Deduct deferred income tax
   Current income tax

[4] Extraordinary item — loss due to earthquake damage
   (net of income tax) for 1984
   Loss due to earthquake damage
   Income tax saving (40% \times $950,000)
   Net of income tax effect

[5] Earnings per share on income before extraordinary item for 1984
   Income before extraordinary item
   Weighted average number of shares outstanding for 1984
   Earnings per share

[6] Earnings per share on net income for 1984
   Net income
   Weighted average number of shares
   Earnings per share
C. Statement of Changes in Financial Position

Bush, Inc., and Subsidiary

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
CASH CONCEPT
For the Year Ended December 31, 1986

Financial resources provided

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash provided by operations</td>
<td>$198,000</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>Minority interest in net income of subsidiary</td>
<td>$33,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>82,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>3,000</td>
</tr>
<tr>
<td>Gain on sale of equipment</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Decrease in allowance to reduce marketable securities to market</td>
<td>(11,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>12,000</td>
</tr>
<tr>
<td>Decrease in accounts receivable</td>
<td>22,000</td>
</tr>
<tr>
<td>Increase in inventories</td>
<td>(70,000)</td>
</tr>
<tr>
<td>Increase in accounts payable and accrued liabilities</td>
<td>121,000</td>
</tr>
<tr>
<td>Cash provided by operations</td>
<td>384,000</td>
</tr>
<tr>
<td>Cash from other sources</td>
<td></td>
</tr>
<tr>
<td>Sale of equipment</td>
<td>40,000</td>
</tr>
<tr>
<td>Sale of treasury stock</td>
<td>44,000</td>
</tr>
<tr>
<td>Financial resources not affecting cash</td>
<td></td>
</tr>
<tr>
<td>Issuance of common stock to purchase land</td>
<td>215,000</td>
</tr>
<tr>
<td>Total financial resources provided</td>
<td>683,000</td>
</tr>
</tbody>
</table>

Financial resources used

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash dividend paid by parent company</td>
<td>$58,000</td>
</tr>
<tr>
<td>Cash dividend paid to minority stockholders of subsidiary</td>
<td>15,000</td>
</tr>
<tr>
<td>Purchase of equipment</td>
<td>127,000</td>
</tr>
<tr>
<td>Payment on note payable</td>
<td>150,000</td>
</tr>
<tr>
<td>Financial resources not affecting cash</td>
<td></td>
</tr>
<tr>
<td>Purchase of land by issuance of common stock</td>
<td>215,000</td>
</tr>
<tr>
<td>Total financial resources used</td>
<td>565,000</td>
</tr>
<tr>
<td>Increase in cash</td>
<td>$118,000</td>
</tr>
</tbody>
</table>

Explanations of Amounts:

[1] Minority interest in net income of subsidiary
Net income of Dorr Corporation in 1986 $110,000
Minority ownership × 30%

Minority interest in net income $33,000
Accounting Practice

[2] Depreciation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated depreciation, 12/31/86</td>
<td>$199,000</td>
</tr>
<tr>
<td>Accumulated depreciation on equipment sold</td>
<td></td>
</tr>
<tr>
<td>($62,000 – $34,000)</td>
<td>28,000</td>
</tr>
<tr>
<td>Deduct accumulated depreciation, 12/31/85</td>
<td>227,000</td>
</tr>
<tr>
<td>Depreciation for 1986</td>
<td>145,000</td>
</tr>
<tr>
<td></td>
<td>$ 82,000</td>
</tr>
</tbody>
</table>

[3] Cash dividends paid to minority stockholders of subsidiary

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash dividend paid by Dorr Corporation</td>
<td>$50,000</td>
</tr>
<tr>
<td>Minority ownership</td>
<td>× 30%</td>
</tr>
<tr>
<td>Cash dividend paid to minority stockholders in 1986</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

1M84 Answer 4 (10 points)

Bergen Corporation

STATEMENT OF CHANGES IN FINANCIAL POSITION
For the Year Ended December 31, 1983

Financial Resources Provided

<table>
<thead>
<tr>
<th>Financial Resources Provided</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital provided by operations</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$253,000</td>
</tr>
<tr>
<td>Add back (or deduct) items that did not use (or provide) 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>(20,000)</td>
</tr>
<tr>
<td>Gain on sale of equipment</td>
<td>(5,000)</td>
</tr>
<tr>
<td></td>
<td>137,000</td>
</tr>
<tr>
<td></td>
<td>390,000</td>
</tr>
<tr>
<td>Working capital from other sources</td>
<td></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>Financial resources not affecting working capital</td>
<td></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>Financial Resources Used</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>Financial resources not affecting working capital</td>
<td></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>
</tbody>
</table>

Increase in working capital                                     | $ 342,000 |
### Unofficial Answers

**1M84**

Answer 4 (cont.)

---

**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>$438,000</td>
<td></td>
<td>$2,021,000</td>
</tr>
<tr>
<td>Land</td>
<td>250,000</td>
<td>100,000</td>
<td></td>
<td>350,000</td>
</tr>
<tr>
<td>Plant &amp; equipment</td>
<td>720,000</td>
<td>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>24,000</td>
<td>[12]149,000</td>
<td>(295,000)</td>
</tr>
<tr>
<td>Leased equipment — capital lease</td>
<td>—</td>
<td>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></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>Note payable, long-term</td>
<td>—</td>
<td>150,000</td>
<td>[5]450,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>—</td>
<td>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>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></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; stockholders’ 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>

<table>
<thead>
<tr>
<th>Sources of Financial Resources</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital provided by operations</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$253,000</td>
<td>[1]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>149,000</td>
<td>[12]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of bond premium</td>
<td>(2,000)</td>
<td>[14]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>15,000</td>
<td>[13]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on sale of securities</td>
<td>(20,000)</td>
<td>[2]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on sale of equipment</td>
<td>(5,000)</td>
<td>[7]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale of securities</td>
<td>95,000</td>
<td>[2]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issuance of common stock to purchase land</td>
<td>100,000</td>
<td>[4]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds of long-term note payable</td>
<td>450,000</td>
<td>[5]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale of equipment</td>
<td>33,000</td>
<td>[7]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>158,000</td>
<td>[9]</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Uses of Financial Resources</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash dividends</td>
<td>$30,000</td>
<td>[3]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of land for common stock</td>
<td>100,000</td>
<td>[4]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of equipment</td>
<td>392,000</td>
<td>[6]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prior period income tax adjustment</td>
<td>20,000</td>
<td>[8]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leased equipment under capital lease</td>
<td>158,000</td>
<td>[9]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment under capital lease</td>
<td>25,000</td>
<td>[10]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reclassification of debt</td>
<td>159,000</td>
<td>[11]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in working capital</td>
<td>342,000</td>
<td>[x]</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total uses</strong></td>
<td>$1,226,000</td>
<td></td>
<td>$1,226,000</td>
<td></td>
</tr>
</tbody>
</table>

AP-217
D. Statement of Owners' Equity

\[1\text{NB}3\]
Answer 4 (10 points)

1. \textit{Ashwood, Inc.}
   \textbf{STATEMENT OF RETAINED EARNINGS}
   \textit{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></td>
</tr>
<tr>
<td>On preferred stock at required rate</td>
<td>450,000</td>
</tr>
<tr>
<td>On common stock, $1.00 per share</td>
<td>2,480,000</td>
</tr>
<tr>
<td>Balance, December 31, 1982</td>
<td>$8,250,000</td>
</tr>
</tbody>
</table>

2. \textit{Ashwood, Inc.}
   \textbf{STOCKHOLDERS' EQUITY SECTION OF BALANCE SHEET}
   \textit{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 x $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>Total</td>
<td>49,700,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less common stock in treasury, 10,000 shares at cost [16 x 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>
Unofficial Answers

1N83
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>3,500,000</td>
</tr>
<tr>
<td>[500,000 \times $7 ($17 - $10)]</td>
<td></td>
</tr>
<tr>
<td>From sale of 10,000 shares treasury stock on</td>
<td>50,000</td>
</tr>
<tr>
<td>November 10, 1982 [10,000 \times $5 ($21 - $16)]</td>
<td></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>5,000,000</td>
</tr>
<tr>
<td>Preferred stock at liquidation value</td>
<td></td>
</tr>
<tr>
<td>[100,000 \text{ shares} \times $50]</td>
<td></td>
</tr>
<tr>
<td>Allocation to common stock</td>
<td>$44,540,000</td>
</tr>
<tr>
<td>[2,490,000 \text{ 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 \div 2,490,000)]</td>
<td></td>
</tr>
</tbody>
</table>
E. Consolidated Financial Statements or Worksheets

1N85
Answer 5 (10 points)

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>Debit</th>
<th>Credit</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 825,000</td>
<td>$ 330,000</td>
<td>[3] $8,000</td>
<td>$ 2,247,000</td>
<td></td>
</tr>
<tr>
<td>Accounts &amp; other receivables</td>
<td>2,140,000</td>
<td>835,000</td>
<td>[4] 720,000</td>
<td>3,265,000</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>2,310,000</td>
<td>1,045,000</td>
<td>[5] 90,000</td>
<td>6,555,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>650,000</td>
<td>300,000</td>
<td></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>
<td></td>
</tr>
<tr>
<td>Investment in Frey, Inc.</td>
<td>2,430,000</td>
<td></td>
<td>[1] 2,430,000</td>
<td></td>
<td></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>
<td></td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td></td>
<td>$15,102,000</td>
</tr>
</tbody>
</table>

| **Liabilities and Stockholders' Equity:** |            |            |       |        |              |
| Accounts payable & other current liabilities | $ 2,465,000 | $1,145,000 | [3] $8,000 | $ 2,882,000 |
| Long-term debt | 1,900,000 | 1,300,000 | [4] 720,000 | 2,880,000 |
| Common stock, $25 par | 3,200,000 | 1,000,000 | [1] 1,000,000 | 3,200,000 |
| Additional paid-in capital | 1,850,000 | 190,000 | [1] 190,000 | 1,850,000 |
| Retained earnings | 4,380,000 | 1,240,000 | [1] 1,240,000 | 4,290,000 |
|                      | $13,795,000| $4,875,000 |       | $3,568,000 | $3,568,000 | $15,102,000 |

Deduct cash dividends paid:

By Frey, Inc., prior to combination | 160,000 [7] |
By Case, Inc., after the combination | 256,000 |

Balance, December 31, 1984 | $4,290,000 |

Explanations of Worksheet Entries & Other Amounts

1. To eliminate the reciprocal elements in investment and equity accounts.
2. To eliminate Case's investment in Frey's bonds.
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 × 10% × 1/4 = $8,000)
Unofficial Answers


[5] To eliminate intercompany profit in ending inventory of Frey. ($180,000 \times \frac{1}{2} = \$90,000)

   Case, Inc. $ 890,000
   Frey, Inc. 580,000
   $1,470,000

Deduct intercompany profit in inventory 90,000[5] $1,380,000

[7] Dividend paid 6/15/84
   [40,000 shares \times \$4] $160,000

1N63
Answer 5 (10 points)

Amboy Corporation and Subsidiary
CONSOLIDATING STATEMENT WORKSHEET
December 31, 1982

Income Statement

<table>
<thead>
<tr>
<th></th>
<th>Amboy Corp.</th>
<th>Taft Inc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>(1,900,000)</td>
<td>(1,500,000)</td>
</tr>
<tr>
<td>Dividends from Taft</td>
<td>(40,000)</td>
<td>40,000</td>
</tr>
<tr>
<td>Gain on sale of warehouse</td>
<td>(30,000)</td>
<td>30,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,180,000</td>
<td>870,000</td>
</tr>
<tr>
<td>Operating expenses (incl. deprec.)</td>
<td>550,000</td>
<td>440,000</td>
</tr>
<tr>
<td>Net income</td>
<td>(240,000)</td>
<td>(190,000)</td>
</tr>
</tbody>
</table>

Retained Earnings Statement

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 1/1/82</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>262,000</td>
<td>164,000</td>
</tr>
<tr>
<td>Dividends paid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, 12/31/82</td>
<td>$418,000</td>
<td>$204,000</td>
</tr>
</tbody>
</table>

Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$435,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>705,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>922,000</td>
</tr>
<tr>
<td>Land, plant &amp; equipment</td>
<td>1,364,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>402,000</td>
</tr>
<tr>
<td>Investment in Taft (at cost)</td>
<td>57,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$3,081,000</td>
</tr>
</tbody>
</table>

Liabilities & stockholders’ equity:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts pay. &amp; accrued exp.</td>
<td>$1,189,000</td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>(1,200,000)</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>(140,000)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(552,000)</td>
</tr>
</tbody>
</table>

(continued)
*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.


[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] x 1/2.

[6] To eliminate intercompany sales from Taft to Amboy and the intercompany profit in Amboy's ending inventory as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>On hand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$180,000</td>
<td>$36,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>90,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>


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

A. Cash, Marketable Securities, and Investments

1N86
Answer 4 (10 points)

a. 

1. Lee, Inc.

SCHEDULE OF LONG-TERM INVESTMENT PORTFOLIO IN MARKETABLE EQUITY SECURITIES CARRIED AT LOWER OF COST OR MARKET

December 31, 1985

<table>
<thead>
<tr>
<th></th>
<th>Date</th>
<th>Ewing</th>
<th>Fox</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>At Cost</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Date</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/84</td>
<td>$125,000</td>
<td>$160,000</td>
<td>$700,000</td>
<td>$985,000</td>
</tr>
<tr>
<td>7/1/85</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8/5/85</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/85</td>
<td>$125,000</td>
<td>$144,000</td>
<td>$</td>
<td>269,000</td>
</tr>
</tbody>
</table>

At Market

<table>
<thead>
<tr>
<th></th>
<th>12/31/85</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares</td>
<td>5,500 [2]</td>
</tr>
<tr>
<td>Price per share</td>
<td>$23 x 10,000</td>
</tr>
<tr>
<td></td>
<td>$14 x 10,000</td>
</tr>
<tr>
<td></td>
<td>$126,500</td>
</tr>
<tr>
<td></td>
<td>$140,000</td>
</tr>
</tbody>
</table>

Valuation allowance to reduce long-term investments in marketable equity securities to market value

$ 2,500
### Investment in Fox Corp., at Equity

<table>
<thead>
<tr>
<th></th>
<th>Underlying equity</th>
<th>Excess of cost</th>
<th>Total at equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% interest, 1/2/84</td>
<td>$580,000</td>
<td>$120,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>Equity in earnings, 1984</td>
<td>35,000</td>
<td></td>
<td>35,000</td>
</tr>
<tr>
<td>Amortization of excess cost</td>
<td></td>
<td>(3,000)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Balance, 12/31/84</td>
<td>615,000</td>
<td>117,000</td>
<td>732,000</td>
</tr>
</tbody>
</table>

Period 1/1/85 to 6/30/85

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity in earnings</td>
<td>20,000</td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Amortization of excess cost</td>
<td></td>
<td>(1,500)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Balance, 6/30/85</td>
<td>635,000</td>
<td>115,500</td>
<td>750,500</td>
</tr>
</tbody>
</table>

20% interest, 7/1/85

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Period 7/1/85 to 12/31/85</td>
<td>1,270,000</td>
<td>250,000</td>
<td>1,520,000</td>
</tr>
<tr>
<td>Equity in earnings</td>
<td>111,000</td>
<td></td>
<td>111,000</td>
</tr>
<tr>
<td>Amortization of excess cost</td>
<td></td>
<td>(4,625)</td>
<td>(4,625)</td>
</tr>
<tr>
<td>Dividend, 10/1/85</td>
<td>(97,500)</td>
<td></td>
<td>(97,500)</td>
</tr>
<tr>
<td>Balance, 12/31/85</td>
<td>$1,918,500</td>
<td>$360,875</td>
<td>$2,279,375</td>
</tr>
</tbody>
</table>

### b.

#### Dividends

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dale Corp., common stock</td>
<td></td>
<td></td>
<td>$4,125</td>
</tr>
</tbody>
</table>

#### Realized gain on sale of securities

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ewing Corp., stock rights</td>
<td></td>
<td></td>
<td>$2,800</td>
</tr>
</tbody>
</table>

#### Equity in earnings of Fox Corp.

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lee's 10% interest in earnings for period</td>
<td></td>
<td></td>
<td>$20,000</td>
</tr>
<tr>
<td>January 1 to June 30, 1985</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lee's 30% interest in earnings for period</td>
<td></td>
<td></td>
<td>111,000</td>
</tr>
<tr>
<td>July 1 to December 31, 1985</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of excess of cost over underlying equity</td>
<td></td>
<td>(6,125)</td>
<td></td>
</tr>
<tr>
<td>Equity in earnings of Fox Corp.</td>
<td></td>
<td></td>
<td>$124,875</td>
</tr>
</tbody>
</table>
Explanations of Amounts:

[1] Ewing common — Allocation of cost to stock and stock rights
Market prices at 8/5/85, date rights issued:

| Shares — $13.50 per share × 10,000 shares | $135,000 (90%) |
| Rights — $ 1.50 per right × 10,000 rights | 15,000 (10%) |
| Cost allocated to shares (90% × $160,000) | $144,000 |
| Cost allocated to rights (10% × $160,000) | 16,000 |
| Total Cost | $160,000 |

[2] Dale common shares
Balance, 12/31/84 | 5,000 |
10% stock dividend, 5/1/85 | 500 |
Total, 12/31/85 | 5,500 |

[3] 10% Interest, 1/2/84
Underlying equity (10% × $5,800,000) | $580,000 |
Excess of cost | 120,000 |
Total paid for 10% interest | $700,000 |

[4] Equity in earnings of Fox
Year ended 12/31/84
(10% interest × $350,000) | $ 35,000 |
Period 1/1/85 to 6/30/85
(10% interest × $200,000) | $ 20,000 |
Period 7/1/85 to 12/31/85
(30% interest × $370,000) | $111,000 |

[5] Amortization of excess cost
Year ended 12/31/84 ($120,000 ÷ 40) | $3,000 |
Period 1/1/85 to 6/30/85 ($3,000 × ½) | $1,500 |
Period 7/1/85 to 12/31/85
10% interest | $1,500 |
20% interest ($250,000 ÷ 40 × ½) | 3,125 |
Total for year ended 12/31/85 | $6,125 |

[6] Dividends received from Fox
10/1/85 (75,000 shares × $1.30) | $97,500 |

[7] Dividend on Dale Corp. stock
Shares owned × $0.75 per share 11/1/85
Dividend received | $ 4,125 |

AP-224
Unofficial Answers

[8] Realized gain on sale of Ewing Corp. stock rights
Sales proceeds, 12/16/85 $18,800
Cost allocated to rights 16,000 [1]
Realized gain $ 2,800

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>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$117,500</td>
</tr>
</tbody>
</table>

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) 292,500
  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

AP-225
**Winsor Company**

**Schedule of Investment Income**

*For the Year Ended December 31, 1983*

<table>
<thead>
<tr>
<th>Dividends:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bea Corp.—preferred (1,000 shares × $2.40 per share)</td>
<td>$2,400</td>
</tr>
<tr>
<td>Cha, Inc.—common (3,500 shares × $1.00 per share)</td>
<td>3,500</td>
</tr>
<tr>
<td><strong>Total dividend income</strong></td>
<td><strong>$5,900</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Realized gain (loss) on sale of securities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cha, Inc.—common ($13 – $10 = $3 × 2,500 shares)</td>
<td>$7,500</td>
</tr>
<tr>
<td>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)</td>
<td>(2,000)</td>
</tr>
<tr>
<td><strong>Net realized gain on sale of securities</strong></td>
<td><strong>$5,500</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Unrealized gain on current marketable equity securities (see Required a.)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity in income of Eddie Corp.</strong> Winsor's 30% interest in Eddie's net income of $1,200,000</td>
<td><strong>$360,000</strong></td>
</tr>
<tr>
<td><strong>Amortization of excess of cost over underlying equity</strong></td>
<td><strong>(7,500)</strong></td>
</tr>
<tr>
<td><strong>Equity in income of Eddie Corp.</strong></td>
<td><strong>$352,500</strong></td>
</tr>
</tbody>
</table>

### E. Receivables and Accruals

**Linden, Inc.**

**Long-Term Receivables Section of Balance Sheet**

*December 31, 1983*

| 9% note receivable from sale of division, due in annual installments of $500,000 to May 1, 1985, less current installment | $500,000 [1] |
| 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 | 400,000 |
| Non-interest-bearing note from sale of patent, net of 15% imputed interest, due April 1, 1985 | 84,105 [2] |
| Installment contract receivable, due in annual installments of $50,000 to July 1, 1987, less current installment | 112,405 [3] |
| **Total long-term receivables** | **$1,096,505** |
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 24,400  
Balance, 4/1/83 75,600  
Add interest earned to 12/31/83 8,505  
Balance, 12/31/83  $ 84,105
1M84
Answer 5 (cont.)

Contract selling price, 7/1/83 $200,000
Less down payment, 7/1/83 60,000
Balance, 12/31/83 140,000
Less installment due, 7/1/84
[$50,000 — ($140,000 × 16%)] 27,600
Long-term portion, 12/31/83 $112,400

[4] Accrued Interest — Note Receivable, Sale of Division, at 12/31/83
Interest accrued from 5/1 to 12/31/83
($1,000,000 × 9% × $/12) $60,000

Interest accrued from 7/1 to 12/31/83
($140,000 × 16% × $/2) $11,200

[6] Interest Income — Note Receivable, Sale of Division, for 1983
Interest earned from 1/1 to 5/1/83
($1,500,000 × 9% × 4/12) $45,000
Interest earned from 5/1 to 12/31/83
($1,000,000 × 9% × $/12) 60,000
Interest income $105,000

[7] Interest Income — Note Receivable, Officer, for 1983
Interest earned 1/1 to 12/31/83
($400,000 × 8%) $32,000

Stated selling price $100,000
Less imputed interest 24,400 [2]
Actual selling price 75,600
Less cost of patent (net)
Carrying value 1/1/83 $40,000
Less amortization 1/1 to 4/1/84
($8,000 × $/4) 2,000 38,000
Gain recognized $37,600

[9] Gain Recognized on Sale of Land
Selling price $200,000
Less cost 150,000
Gain recognized $50,000
Unofficial Answers

1M83
Answer 4 (10 points)

Part a.

1. **Harris Corporation**

**ANALYSIS OF CHANGES IN THE ALLOWANCE FOR DOUBTFUL ACCOUNTS**

*For the Year Ended December 31, 1982*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at January 1, 1982</td>
<td>$130,000</td>
</tr>
<tr>
<td>Provision for doubtful accounts ($9,000,000 x 2%)</td>
<td>180,000</td>
</tr>
<tr>
<td>Recovery in 1982 of bad debts written off previously</td>
<td>15,000</td>
</tr>
<tr>
<td>Deduct write-offs for 1982 ($90,000 + $60,000)</td>
<td>150,000</td>
</tr>
<tr>
<td>Balance at December 31, 1982, before change in accounting estimate</td>
<td>175,000</td>
</tr>
<tr>
<td>Increase due to change in accounting estimate during 1982 ($235,300 - $175,000)</td>
<td>60,300</td>
</tr>
<tr>
<td>Balance at December 31, 1982, adjusted (Schedule 1)</td>
<td>$235,300</td>
</tr>
</tbody>
</table>

**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>70,000*</td>
<td>75</td>
<td>52,500</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>$235,300</strong></td>
</tr>
</tbody>
</table>

* $130,000 - $60,000

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></td>
<td>$60,300</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>To increase the allowance for doubtful</td>
<td>$60,300</td>
<td></td>
</tr>
<tr>
<td>accounts at December 31, 1982, resulting from a change in accounting estimate.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

AP-229
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><strong>Current inventory at current year cost</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product A</td>
<td>17,000 × $35 = $595,000</td>
<td>13,000 × $40 = $520,000</td>
</tr>
<tr>
<td>Product B</td>
<td>9,000 × $28 = 252,000</td>
<td>10,000 × $32 = 320,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$847,000</td>
<td>$840,000</td>
</tr>
</tbody>
</table>

| **Current inventory at base cost** |                  |                  |
| Product A           | 17,000 × $30 = $510,000 | 13,000 × $30 = $390,000 |
| Product B           | 9,000 × $25 = 225,000 | 10,000 × $25 = 250,000 |
| **Total**           | $735,000          | $640,000          |

**Conversion price index**

$847,000 ÷ $735,000 = 1.15

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><strong>December 31, 1981</strong></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(^a)</td>
<td>201,250</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$735,000(^a)</strong></td>
<td><strong>1.15</strong></td>
<td><strong>$761,250</strong></td>
</tr>
</tbody>
</table>

| **December 31, 1982** |                                |                        |                        |
| Base inventory      | $560,000                        | 1.00                   | $560,000               |
| 1981 layer (remaining) | 80,000\(^b\)                   | 1.15\(^a\)           | 92,000                 |
| 1982 layer          | 0                               | 1.31\(^a\)           | 0                      |
| **Total**           | **$640,000\(^a\)**              |                        | **$652,000**           |

\(^a\) See Computation of Internal Conversion Price Index, above.
\(^b\) After liquidation of $95,000 at base cost:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A (4,000 × $30)</td>
<td>$120,000</td>
</tr>
<tr>
<td>Product B (1,000 × $25)</td>
<td>(25,000)</td>
</tr>
<tr>
<td><strong>Net</strong></td>
<td><strong>$ 95,000</strong></td>
</tr>
</tbody>
</table>
Unofficial Answers

D. Property, Plant, and Equipment Owned or Leased

1M85
Answer 4 (10 points)

Blake Corporation
DEPRECIATION AND AMORTIZATION EXPENSE
For the Year Ended December 31, 1984

<table>
<thead>
<tr>
<th>Description</th>
<th>Book Value 1/1/84</th>
<th>Depreciation Rate</th>
<th>Depreciation Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$1,200,000 - $263,100</td>
<td>150% declining balance rate ((100% ÷ 25) × 1.5))</td>
<td>$56,214</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>$900,000</td>
<td>10%</td>
<td>87,700</td>
</tr>
<tr>
<td>Automotive equipment</td>
<td>$115,000</td>
<td>SYD 3d year 4/10</td>
<td>16,200</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>$168,000</td>
<td>Amortization period (5/1/84 to 12/31/90)</td>
<td>16,800</td>
</tr>
</tbody>
</table>

Total depreciation and amortization expense for 1984 $197,789
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 × 10% × $23,000) 353,775
Balance, 12/31/84 $342,275

Accumulated depreciation — automotive equipment at 12/31/84
Balance, 1/1/84 $84,600
Depreciation for 1984 21,000
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 × 10% × $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
Net gain on asset disposals for 1984 $3,300
Unofficial Answers

1N05
Answer 4 (cont.)

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

E. Intangibles and Other Assets

1N05  
Answer 4 (10 points)
a.  
Munn, Inc.  
SCHEDULE OF EXPENSES RELATING TO OTHER NONCURRENT ASSETS  
For the Year Ended December 31, 1984

Amortization of intangibles
- Patent: $28,000 [1]  
- Trademark: $15,000 [2]  
- Non-competition agreement: $40,000 [3]  
Total: $83,000

Consulting fee to Cody Corporation: $50,000

Deferred income tax expense: $2,000 [4]

AP-233
b.  

**Munn, Inc.**  
**OTHER NONCURRENT ASSET SECTION**  
**OF BALANCE SHEET**  
**December 31, 1984**

Investment in bonds $929,150 [5]  
Patent, net of accumulated amortization of $52,000 140,000 [6]  
Trademark, net of accumulated amortization of $15,000 585,000 [7]  
Non-competition agreement, net of accumulated amortization of $40,000 160,000 [8]  
Deferred income tax charges 34,000 [9]  
Total other noncurrent assets $1,848,150

**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
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
Accounting Practice

1IN84
Answer 4 (cont.)

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

---

**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  
  - **Long-term portion, 12/31/83** $344,828

---

AP-236
[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 6,440
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% × 6/12) $ 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

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

A. Preferred and Common Stock

Carr Corporation
STATEMENT OF RETAINED EARNINGS
For the Year Ended December 31, 1985

Balance, December 31, 1984
As originally reported $4,000,000
Deduct prior period adjustment
error overstating rent income for year ended December 31, 1984 $500,000
Less income tax effect 225,000 275,000
As restated 3,725,000 Net income 2,600,000 6,325,000
Deduct dividends
Cash dividend on preferred stock 180,000 [1] Dividend in kind on common stock 630,000 [2] 810,000
Balance, December 31, 1985 $5,515,000
b. **Carr Corporation**

**STOCKHOLDERS’ EQUITY SECTION OF BALANCE SHEET**

*December 31, 1985*

Preferred stock, $100 par, 10% cumulative; 100,000 shares authorized; 18,000 shares issued and outstanding  
$1,800,000

Common stock, $5 stated value; 3,000,000 shares authorized, 1,290,000 shares issued and outstanding  
6,450,000 [3]

Additional paid-in capital  
From preferred stock  
$90,000

From common stock  
4,880,000 [4]

Total additional paid-in capital  
4,970,000

Retained earnings  
5,515,000

Less net unrealized loss on noncurrent marketable equity securities  
135,000

Total stockholders’ equity  
$18,600,000

**Explanations of Amounts**

Shares outstanding  
18,000

Dividend per share ($100 par × 10%)  
× $10

Total dividend  
$180,000

Bush, Inc., common stock shares  
10,000

Market price on 2/15/85 declaration date  
× $63

Total dividend  
$630,000

[3] Common stock  

<table>
<thead>
<tr>
<th>Date</th>
<th>Shares</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/84</td>
<td>1,030,000</td>
<td>$5,150,000</td>
</tr>
<tr>
<td>1/10/85</td>
<td>30,000</td>
<td>150,000</td>
</tr>
<tr>
<td></td>
<td>1,000,000</td>
<td>5,000,000</td>
</tr>
<tr>
<td>4/25/85</td>
<td>210,000</td>
<td>1,050,000</td>
</tr>
<tr>
<td>7/1/85</td>
<td>80,000</td>
<td>400,000</td>
</tr>
<tr>
<td>12/31/85</td>
<td>1,290,000</td>
<td>$6,450,000</td>
</tr>
</tbody>
</table>

[4] Additional paid-in capital from common stock  
12/31/84, balance  
$3,500,000

1/10/85, deduct treasury stock retired ($270,000 − $150,000)  
120,000

4/25/85, stock rights exercised [($11 − $5) × 210,000 shares]  
1,260,000

7/1/85, employee stock options exercised [($8 − $5) × 80,000 shares]  
240,000

12/31/85, balance  
$4,880,000
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

VII. Cost Accumulation, Planning, and Control

Leif Company
Sigma Division

SCHEDULE OF EXPECTED ANNUAL CONTRIBUTION MARGIN
FOR KACE AT VARIOUS SALES PRICES

<table>
<thead>
<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>
</tr>
</thead>
<tbody>
<tr>
<td>$6</td>
<td>83,000 [1]</td>
<td>$498,000</td>
<td>$249,000</td>
<td>$249,000</td>
</tr>
<tr>
<td>7</td>
<td>79,000 [2]</td>
<td>553,000</td>
<td>237,000</td>
<td>316,000</td>
</tr>
<tr>
<td>8</td>
<td>74,000 [3]</td>
<td>592,000</td>
<td>222,000</td>
<td>370,000</td>
</tr>
</tbody>
</table>

[1] 70,000 x 10% = 7,000  [2] 70,000 x 40% = 28,000  [3] 70,000 x 70% = 49,000
80,000 x 50% = 40,000  80,000 x 30% = 24,000  80,000 x 20% = 16,000
90,000 x 40% = 36,000  90,000 x 30% = 27,000  90,000 x 10% = 9,000
83,000  79,000  74,000

AP-239
Accounting Practice

2N85
Answer 5 (cont.)

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%.

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>$825,000</td>
<td>$1,065,000</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>
</tbody>
</table>

AP-240
Unofficial Answers

Excess of cash collections over cash disbursements from operations 

<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>

Payments to general creditors 

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>165,000</td>
<td>285,000</td>
</tr>
<tr>
<td>Balance of cash at end</td>
<td>$75,000</td>
<td>$15,000</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] \((600,000 \times 60\%) - (50,000 + 40,000)\)

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>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 \(\times \frac{2}{12} = 2,000\); 2,000 \(\times \$20\) per unit = \$40,000

[4] 15,000 units \(\times \frac{2}{12} = 2,500\); 2,500 \(\times \$20\) per unit = \$50,000

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>

AP-241
Accounting Practice

2N84
Answer 5 (10 points)

a.

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>Total (000 omitted)</th>
<th>Per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales $2,200</td>
<td>$20</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
</tr>
<tr>
<td>Direct material 550</td>
<td>5</td>
</tr>
<tr>
<td>Direct labor 660</td>
<td>6</td>
</tr>
<tr>
<td>Factory overhead 440</td>
<td>4</td>
</tr>
<tr>
<td>Total variable costs 1,650</td>
<td>15</td>
</tr>
<tr>
<td>Contribution margin $550</td>
<td>$5</td>
</tr>
</tbody>
</table>

Units required to cover fixed factory overhead and fixed regional promotional costs:

\[
\frac{($700,000 + $100,000)}{5} = 160,000 \text{ units of Xoff}
\]

b.

1.

Poe Corp.
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>(000 omitted)</th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales $7,400</td>
<td>$3,400</td>
<td>$4,000</td>
<td></td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material 1,850</td>
<td>850</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Direct labor 2,020</td>
<td>1,020</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Factory overhead 1,380</td>
<td>680</td>
<td>700</td>
<td></td>
</tr>
<tr>
<td>Total variable costs 5,250</td>
<td>2,550</td>
<td>2,700</td>
<td></td>
</tr>
<tr>
<td>Contribution margin 2,150</td>
<td>850</td>
<td>1,300</td>
<td></td>
</tr>
<tr>
<td>Fixed costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Factory overhead 1,600</td>
<td>700</td>
<td>900</td>
<td></td>
</tr>
<tr>
<td>Regional promotional 320</td>
<td>220</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Total fixed costs 1,920</td>
<td>920</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Plant operating income (loss) 230</td>
<td>(70)</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Allocated home office costs 310</td>
<td>142*</td>
<td>168**</td>
<td></td>
</tr>
<tr>
<td>Operating income (loss) $ (80)</td>
<td>$ (212)</td>
<td>$ 132</td>
<td></td>
</tr>
</tbody>
</table>

\[
*\frac{3,400}{7,400} \times 310 = 142
\]

\[
**\frac{4,000}{7,400} \times 310 = 168
\]

AP-242
Unofficial Answers

2N84
Answer 5 (cont.)

2.

**Poe Corp.**

**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>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,200</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variable factory costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct material:</td>
</tr>
<tr>
<td>1,550</td>
</tr>
<tr>
<td>Direct labor:</td>
</tr>
<tr>
<td>1,550</td>
</tr>
<tr>
<td>Factory overhead:</td>
</tr>
<tr>
<td>1,085</td>
</tr>
</tbody>
</table>

**Total variable costs**

<table>
<thead>
<tr>
<th>Contribution margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,015</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fixed costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factory overhead:</td>
</tr>
<tr>
<td>950</td>
</tr>
<tr>
<td>Regional promotional:</td>
</tr>
<tr>
<td>200</td>
</tr>
</tbody>
</table>

**Total fixed costs**

<table>
<thead>
<tr>
<th>Plant operating income</th>
</tr>
</thead>
<tbody>
<tr>
<td>865</td>
</tr>
<tr>
<td>Allocated home office costs</td>
</tr>
<tr>
<td>310</td>
</tr>
<tr>
<td>Operating income</td>
</tr>
<tr>
<td>$ 555</td>
</tr>
</tbody>
</table>

3.

**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>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Royalties</td>
</tr>
<tr>
<td>Total revenues</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variable factory costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct material:</td>
</tr>
<tr>
<td>1,000</td>
</tr>
<tr>
<td>Direct labor:</td>
</tr>
<tr>
<td>1,000</td>
</tr>
<tr>
<td>Factory overhead:</td>
</tr>
<tr>
<td>700</td>
</tr>
</tbody>
</table>

**Total variable costs**

<table>
<thead>
<tr>
<th>Contribution margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,575</td>
</tr>
<tr>
<td>275</td>
</tr>
<tr>
<td>1,300</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fixed costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factory overhead:</td>
</tr>
<tr>
<td>950</td>
</tr>
<tr>
<td>Regional promotional:</td>
</tr>
<tr>
<td>200</td>
</tr>
</tbody>
</table>

**Total fixed costs**

<table>
<thead>
<tr>
<th>Plant operating income and royalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>425</td>
</tr>
<tr>
<td>125</td>
</tr>
<tr>
<td>300</td>
</tr>
<tr>
<td>Allocated home office costs</td>
</tr>
<tr>
<td>310</td>
</tr>
<tr>
<td>Operating income (loss)</td>
</tr>
<tr>
<td>$ 115</td>
</tr>
<tr>
<td>$125</td>
</tr>
<tr>
<td>$(10)</td>
</tr>
</tbody>
</table>

AP-243
1. **Mat Company**
   **SCHEDULE OF COST OF GOODS MANUFACTURED**
   *For the Month Ended March 31, 1984*

   Work in process — beginning inventory $40,000
   
   Production costs
   - Direct materials $104,000
   - Direct labor 160,000
   - Factory overhead applied 80,000 344,000
   
   Production costs available 384,000
   
   Less work in process — ending inventory 36,000
   
   Cost of goods manufactured $348,000

2. **Mat Company**
   **SCHEDULE OF PRIME COST**
   *For the Month Ended March 31, 1984*

   Direct materials
   - Beginning inventory $20,000
   - Purchases 110,000
   
   Direct materials available 130,000
   
   Less ending inventory 26,000
   
   Direct materials used 104,000
   
   Direct labor 160,000
   
   Total prime cost $264,000

3. **Mat Company**
   **SCHEDULE OF CONVERSION COST**
   *For the Month Ended March 31, 1984*

   Direct labor $160,000
   
   Factory overhead applied (50% of direct labor) 80,000
   
   Total conversion cost $240,000

2M84

Answer 5 (10 points)

**a. Beal Company**

**SCHEDULE OF BUDGETED PRODUCTION COSTS**
*BASED ON 7,800 UNITS*

*For the Month Ended January 31, 1984*

<table>
<thead>
<tr>
<th>Item</th>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>7,800 units × 3 lbs. × $2.50</td>
<td>$58,500</td>
</tr>
<tr>
<td>Direct labor</td>
<td>7,800 units × 5 hrs. × $7.50</td>
<td>292,500</td>
</tr>
<tr>
<td>Factory overhead</td>
<td></td>
<td>117,000</td>
</tr>
<tr>
<td>Variable</td>
<td>7,800 units × 5 hrs. × $3.00</td>
<td>40,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>40,000 hrs. × $4.00</td>
<td>160,000</td>
</tr>
<tr>
<td>Total budgeted production costs</td>
<td></td>
<td>$628,000</td>
</tr>
</tbody>
</table>

AP-244
b.  

1. Direct materials price variance based on materials purchased  
   \[ ($2.60 - $2.50) \times 25,000 \text{ lbs.} \]  
   \[ $2,500 \text{ unfavorable} \]

2. Direct materials usage variance  
   \[ [23,100 \text{ lbs.} - (7,800 \text{ units} \times 3 \text{ hrs.})] \times $2.50 \]  
   \[ $750 \text{ favorable} \]

3. Direct labor rate variance  
   \[ ($7.30 - $7.50) \times 40,100 \text{ hrs.} \]  
   \[ $8,020 \text{ favorable} \]

4. Direct labor efficiency variance  
   \[ [40,100 \text{ hrs.} - (7,800 \text{ units} \times 5 \text{ hrs.})] \times $7.50 \]  
   \[ $8,250 \text{ unfavorable} \]

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  
   \[ $19,700 \text{ unfavorable} \]

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  
   \[ $3,300 \text{ unfavorable} \]

7. Factory overhead volume variance  
   Budgeted total factory overhead at standard hours  
   \[ $277,000 \]  
   
   Applied total factory overhead (7,800 \times 5 \text{ hrs.} \times $7.00)  
   \[ 273,000 \]  
   
   Factory overhead volume variance  
   \[ $4,000 \text{ unfavorable} \]

2M83

Answer 4

a. The breakeven point in patient days equals total fixed cost divided by contribution margin per patient day.

**Pediatrics**

**COMPUTATION OF BREAKEVEN POINT IN PATIENT DAYS**

*For the Year Ending June 30, 1983*

<table>
<thead>
<tr>
<th>Total fixed costs (Schedule 1)</th>
<th>$3,380,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Divided by contribution margin per patient day (Schedule 2)</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>Melford Hospital charges</th>
<th>Total Fixed Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supervising nurses</td>
<td>$2,900,000</td>
</tr>
<tr>
<td>Nurses</td>
<td>100,000</td>
</tr>
<tr>
<td>Aides</td>
<td>200,000</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>$3,380,000</td>
</tr>
</tbody>
</table>

AP-245
Schedule 2

<table>
<thead>
<tr>
<th>Contribution Margin Per Patient Day</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue per patient day</td>
</tr>
<tr>
<td>Variable costs per patient day</td>
</tr>
<tr>
<td>($6,000,000 ÷ $300 = 20,000 patient days)</td>
</tr>
<tr>
<td>($2,000,000 ÷ 20,000 patient days)</td>
</tr>
<tr>
<td>Contribution margin per patient day</td>
</tr>
<tr>
<td>$300</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

b.

**Pediatrics**

**COMPUTATION OF LOSS FROM RENTAL OF ADDITIONAL 20 BEDS**

*For the Year Ending June 30, 1983*

Increase in revenue (20 additional beds × 90 days × $300 charge per day) $ 540,000

Increase in expenses

Variable charges by Melford Hospital

(20 additional beds × 90 days × $100 per day) 180,000

Fixed charges by Melford Hospital

($2,900,000 ÷ 60 beds = $48,333 per bed × 20 beds) 966,667

or [$2,900,000 × (20 ÷ 60)]

Salaries expense

(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)

Total increase in expenses 1,146,667

Net decrease in earnings from rental of additional 20 beds $ 606,667
VIII. Not-for-Profit and Governmental Accounting

### Esperanza Hospital

**WORKSHEET TO ADJUST GENERAL LEDGER BALANCES AND TO ESTABLISH SEPARATE FUNDS**

*January 1, 1987*

<table>
<thead>
<tr>
<th>Account</th>
<th>Trial Balance December 31, 1986</th>
<th>Adjustments</th>
<th>General (Unrestricted) Funds</th>
<th>Endowment Fund</th>
<th>Plant Replacement and Expansion Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
</tr>
<tr>
<td>Cash</td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
<td>60,000</td>
</tr>
<tr>
<td>Investment in U.S. Treasury</td>
<td>400,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>bills</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in corporate</td>
<td>500,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>bonds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest receivable</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>50,000</td>
<td></td>
<td></td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>30,000</td>
<td></td>
<td></td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td>Land</td>
<td>100,000</td>
<td></td>
<td>60,000(2)</td>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td>Building</td>
<td>800,000</td>
<td></td>
<td></td>
<td></td>
<td>800,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>170,000</td>
<td></td>
<td></td>
<td></td>
<td>170,000</td>
</tr>
<tr>
<td>Allowance for depreciation</td>
<td>410,000</td>
<td></td>
<td>336,000(3)</td>
<td></td>
<td>746,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>20,000</td>
<td></td>
<td></td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>70,000</td>
<td></td>
<td></td>
<td></td>
<td>70,000</td>
</tr>
<tr>
<td>Endowment fund balance</td>
<td>520,000</td>
<td></td>
<td>120,000(1)</td>
<td></td>
<td>400,000</td>
</tr>
<tr>
<td>Other fund balances</td>
<td>1,100,000</td>
<td></td>
<td>1,100,000(6)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Esperanza Hospital

WORKSHEET TO ADJUST GENERAL LEDGER BALANCES
AND TO ESTABLISH SEPARATE FUNDS
January 1, 1987

<table>
<thead>
<tr>
<th>Account</th>
<th>Trial Balance December 31, 1986</th>
<th>Adjustments</th>
<th>General (Unrestricted) Funds</th>
<th>Endowment Fund</th>
<th>Plant Replacement and Expansion Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
</tr>
<tr>
<td>Due from general (unrestricted) funds</td>
<td></td>
<td>246,000(4)</td>
<td></td>
<td></td>
<td>246,000</td>
</tr>
<tr>
<td>Due to plant replacement and expansion fund</td>
<td></td>
<td>246,000(5)</td>
<td>246,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant replacement and expansion fund balance</td>
<td></td>
<td>246,000(4)</td>
<td>500,000(6)</td>
<td></td>
<td>746,000</td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td>60,000(2)</td>
<td>120,000(1)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>336,000(3)</td>
<td>600,000(6)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>246,000(5)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>2,120,000</td>
<td>2,120,000</td>
<td>2,108,000</td>
<td>1,160,000</td>
<td>400,000</td>
</tr>
</tbody>
</table>
Unofficial Answers

2M87
Answer 5 (cont.)

Esperanza Hospital
ADJUSTING JOURNAL ENTRIES
January 1, 1987

(Not Required)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Endowment fund balance</td>
<td>120,000</td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td>120,000</td>
</tr>
</tbody>
</table>

To transfer investment income

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>General (unrestricted) funds balance</td>
<td>60,000</td>
</tr>
<tr>
<td>Land</td>
<td>60,000</td>
</tr>
</tbody>
</table>

To eliminate appreciation in land value

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>General (unrestricted) funds balance</td>
<td>336,000</td>
</tr>
<tr>
<td>Allowance for depreciation</td>
<td>336,000</td>
</tr>
</tbody>
</table>

To correct allowance for depreciation account as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building — $720,000 × 2% × 40 years</td>
<td>$576,000</td>
</tr>
<tr>
<td>Elevator — 80,000 × 5% × 20 years</td>
<td>80,000</td>
</tr>
<tr>
<td>Equipment (correctly computed)</td>
<td>90,000</td>
</tr>
<tr>
<td>Correct allowance for depreciation</td>
<td>746,000</td>
</tr>
<tr>
<td>Balance per books</td>
<td>410,000</td>
</tr>
<tr>
<td>Understatement</td>
<td>$336,000</td>
</tr>
</tbody>
</table>

Due from general (unrestricted) funds

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant replacement and expansion fund balance</td>
<td>246,000</td>
</tr>
</tbody>
</table>

Adjusted allowance for depreciation

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in corporate bonds</td>
<td>$746,000</td>
</tr>
<tr>
<td>Underfunded for asset replacement</td>
<td>$246,000</td>
</tr>
</tbody>
</table>

Due to plant replacement and expansion fund

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>General (unrestricted) funds balance</td>
<td>246,000</td>
</tr>
</tbody>
</table>

Other fund balances

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant replacement and expansion fund balance</td>
<td>500,000</td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td>600,000</td>
</tr>
</tbody>
</table>

To allocate other fund balances

AP-249
Pine City
SPECIAL ASSESSMENT FUND
JOURNAL ENTRIES
For the Year Ended December 31, 1985

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. January</td>
<td>Estimated revenues control - estimated revenues control $4,200,000</td>
<td>$4,200,000</td>
<td></td>
</tr>
<tr>
<td>2. January</td>
<td>Encumbrances control - fund balance reserved for encumbrances 9,500,000</td>
<td>9,500,000</td>
<td>9,500,000</td>
</tr>
<tr>
<td>3. January</td>
<td>Cash - other financing sources control 10,000,000</td>
<td>10,000,000</td>
<td>10,000,000</td>
</tr>
<tr>
<td>4. January</td>
<td>Special assessments receivable - current 3,000,000; special assessments receivable - deferred 6,000,000</td>
<td>3,000,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td>5. January</td>
<td>Investments - cash 8,000,000</td>
<td>8,000,000</td>
<td></td>
</tr>
<tr>
<td>6. January</td>
<td>Expenditures control - cash 1,500,000</td>
<td>1,500,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td></td>
<td>Fund balance reserved for encumbrances - cash 1,500,000</td>
<td>1,500,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td>7. June</td>
<td>Cash - special assessments receivable - current 3,000,000</td>
<td>3,000,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td>8. June</td>
<td>Cash - investments 8,480,000</td>
<td>8,480,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investments - cash 8,000,000</td>
<td></td>
<td>8,000,000</td>
</tr>
<tr>
<td></td>
<td>Revenues control - cash 480,000</td>
<td></td>
<td>480,000</td>
</tr>
<tr>
<td>9. July</td>
<td>Investments - cash 11,000,000</td>
<td>11,000,000</td>
<td>11,000,000</td>
</tr>
<tr>
<td>10. November</td>
<td>Expenditures control - vouchers payable 2,100,000</td>
<td>2,100,000</td>
<td>2,100,000</td>
</tr>
<tr>
<td></td>
<td>Fund balance reserved for encumbrances - cash 2,100,000</td>
<td>2,100,000</td>
<td>2,100,000</td>
</tr>
</tbody>
</table>

AP-250
### Unofficial Answers

2N86  
**Answer 4 (cont.)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>11. <em>December 31</em></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>11,500,000</td>
<td>11,000,000</td>
</tr>
<tr>
<td>Investments</td>
<td></td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Revenues control</td>
<td></td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>12. <em>December 31</em></td>
<td>Vouchers payable</td>
<td>$ 2,100,000</td>
<td>$ 2,100,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>13. <em>December 31</em></td>
<td>Expenditures control</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>2,120,000</td>
<td>2,120,000</td>
</tr>
<tr>
<td>14. <em>December 31</em></td>
<td>Expenditures control</td>
<td>610,000</td>
<td>[C] 610,000</td>
</tr>
<tr>
<td>Interest payable</td>
<td></td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Interest receivable</td>
<td></td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Revenues control</td>
<td></td>
<td>300,000</td>
<td>300,000</td>
</tr>
</tbody>
</table>

[A] Special assessment revenue  
$3,000,000  
Interest on deferred special assessment revenue:  
$6,000,000 × 10% × 1/2  
$300,000  
Interest on certificates of deposit  
$900,000  
$4,200,000

[B] Payments to contractor:  
In advance  
$6,000,000 × 30%  
$1,800,000  
Interest on serial bonds:  
$2,000,000 × 6%  
$120,000  
3,000,000 × 7%  
$210,000  
5,000,000 × 8%  
$400,000  
Repayment of bond principal  
2,000,000  
$6,030,000

[C]  
$3,000,000 × 7%  
$210,000  
5,000,000 × 8%  
$400,000  
$610,000

AP-251
2M86
Answer 5 (10 points)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 25,000</td>
<td>$ 25,000</td>
</tr>
</tbody>
</table>

a. Local government

[1] General fund

Expenditures control
Cash $ 25,000

General fixed assets account group

Equipment
Investment in general fixed assets from general fund revenues 25,000


Cash
Revenues control $ 100,000

[3] Nonexpendable trust (endowment) fund

Cash
Operating revenues control $ 55,000
Investments $ 5,000


Cash
Other financing sources control $ 1,000,000

Expenditures control
Cash $ 1,000,000

General long-term debt account group

Amount to be provided for retirement of general long-term debt
General obligation bonds payable 1,000,000 $ 1,000,000

General fixed assets account group

Buildings
Investment in general fixed assets from capital projects funds $ 1,000,000
Unofficial Answers

2M86
Answer 5 (cont.)

b. Voluntary health and welfare organization

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>[1] Current unrestricted fund</td>
<td></td>
</tr>
<tr>
<td>Fund balance — undesignated</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>Plant fund</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>25,000</td>
</tr>
<tr>
<td>Fund balance — expended</td>
<td></td>
</tr>
<tr>
<td>[2] Current unrestricted fund</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
<tr>
<td>Contributions</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>55,000</td>
</tr>
<tr>
<td>Due to current unrestricted fund (or investment income)</td>
<td>5,000</td>
</tr>
<tr>
<td>Investments</td>
<td>50,000</td>
</tr>
<tr>
<td>[4] Plant fund</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Bonds payable</td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

2N85
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

AP-253
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

Community Association for Handicapped Children
STATEMENT OF SUPPORT, REVENUE, AND EXPENSES
AND CHANGES IN FUND BALANCES
FOR CURRENT FUNDS
Year Ended June 30, 1984

Public support and revenue

<table>
<thead>
<tr>
<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>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Membership dues</td>
<td>25,000</td>
<td>—</td>
</tr>
<tr>
<td>Program service fees</td>
<td>30,000</td>
<td>—</td>
</tr>
<tr>
<td>Investment income</td>
<td>10,000</td>
<td>—</td>
</tr>
<tr>
<td>Total revenue</td>
<td>65,000</td>
<td>—</td>
</tr>
<tr>
<td>Total public support and revenue</td>
<td>363,000</td>
<td>15,000</td>
</tr>
</tbody>
</table>

Expenses

<table>
<thead>
<tr>
<th>Unrestricted</th>
<th>Restricted</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Blind children</td>
<td>150,000</td>
<td>—</td>
</tr>
<tr>
<td>Deaf children</td>
<td>120,000</td>
<td>—</td>
</tr>
<tr>
<td>Total program services</td>
<td>270,000</td>
<td>—</td>
</tr>
<tr>
<td>Supporting services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management and general</td>
<td>45,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Fund-raising</td>
<td>8,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Total supporting services</td>
<td>53,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Total expenses</td>
<td>323,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Excess of public support and revenue over expenses 40,000 10,000 50,000
Other changes in fund balances

<table>
<thead>
<tr>
<th>Unrestricted</th>
<th>Restricted</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfers of endowment fund income</td>
<td>20,000</td>
<td>—</td>
</tr>
<tr>
<td>Fund balances, July 1, 1983</td>
<td>38,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Fund balances, June 30, 1984</td>
<td>$ 98,000</td>
<td>$13,000</td>
</tr>
</tbody>
</table>
Unofficial Answers

2M85
Answer 5 (cont.)

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></td>
<td>Unrestricted</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>$150,000</strong></td>
</tr>
<tr>
<td></td>
<td>Restricted</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>Bequest receivable</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$14,000</strong></td>
</tr>
</tbody>
</table>

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>$220,000</td>
<td></td>
</tr>
<tr>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>200,000</td>
<td>$360,000</td>
</tr>
<tr>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td>12,000</td>
<td></td>
</tr>
</tbody>
</table>

AP-255
### Answer 4 (cont.)

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
Rapapo State University  
SUMMARY JOURNAL ENTRIES  
For the Year Ended July 31, 1983

<table>
<thead>
<tr>
<th>Entry no.</th>
<th>Accounts</th>
<th>Current Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Unrestricted</td>
</tr>
<tr>
<td></td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>1.</td>
<td>Cash</td>
<td>$3,000,000</td>
</tr>
<tr>
<td></td>
<td>Accounts receivable—tuition and fees</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenue—tuition and fees</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deferred revenue—tuition and fees</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Deferred revenue—tuition and fees</td>
<td>25,000</td>
</tr>
<tr>
<td></td>
<td>Revenue—tuition and fees</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Allowance for doubtful accounts</td>
<td>13,000</td>
</tr>
<tr>
<td></td>
<td>Accounts receivable—tuition and fees</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Provision for uncollectible tuition and fees</td>
<td>8,000</td>
</tr>
<tr>
<td></td>
<td>Allowance for doubtful accounts</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>State appropriation receivable</td>
<td>60,000</td>
</tr>
<tr>
<td></td>
<td>Revenue—state appropriation</td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Cash</td>
<td>80,000</td>
</tr>
<tr>
<td></td>
<td>Revenue—gifts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fund balance</td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>Cash</td>
<td>$31,000</td>
</tr>
<tr>
<td></td>
<td>Investments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fund balance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fund balance</td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td>Expenditures—general expenses</td>
<td>2,500,000</td>
</tr>
<tr>
<td></td>
<td>Accounts payable</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounts payable</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td>Accounts payable</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>9.</td>
<td>Due to other funds</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>10.</td>
<td>Expenditures—general expenses</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>Prepaid expenses</td>
<td></td>
</tr>
</tbody>
</table>
Rapapo State University
STATEMENT OF CHANGES IN FUND BALANCES
For the Year Ended July 31, 1983

Current Funds

<table>
<thead>
<tr>
<th></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>18,000</td>
<td></td>
</tr>
<tr>
<td>Total revenues and other additions</td>
<td>2,665,000</td>
<td>24,000</td>
</tr>
</tbody>
</table>

| Expenditures and other deductions: |            |            |
| Educational and general         | 2,518,000   |            |

| Transfer among funds (deduction): |            |            |
| Allocation to loan fund          | (30,000)    |            |

| Net increase for the year       | 117,000     | 24,000     |

| Fund balance at beginning of year | 435,000 | 215,000 |

| Fund balance at end of year     | $552,000    | $239,000   |

Community Sports Club
TRANSACTIONS
For the Year Ended March 31, 1983

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenue — annual dues</td>
<td>$20,000</td>
</tr>
<tr>
<td>(2)</td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenue — snack bar and soda fountain</td>
<td>28,000</td>
</tr>
<tr>
<td>(3)</td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investment income</td>
<td>6,000</td>
</tr>
<tr>
<td>(4)</td>
<td>Expense — house</td>
<td>17,000</td>
</tr>
<tr>
<td></td>
<td>Expense — snack bar and soda fountain</td>
<td>26,000</td>
</tr>
<tr>
<td></td>
<td>Expense — general and administrative</td>
<td>11,000</td>
</tr>
<tr>
<td></td>
<td>Accounts payable</td>
<td>54,000</td>
</tr>
<tr>
<td>(5)</td>
<td>Accounts payable</td>
<td>55,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>55,000</td>
</tr>
<tr>
<td>(6)</td>
<td>Assessments receivable</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>Deferred capital support</td>
<td></td>
</tr>
<tr>
<td>(7)</td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenue — bequest (unrestricted revenue)</td>
<td>5,000</td>
</tr>
</tbody>
</table>
## Unofficial Answers

2M83

Answer 5 (cont.)

### Community Sports Club

**ADJUSTMENTS**

*March 31, 1983*

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Investments</td>
<td>$7,000</td>
</tr>
<tr>
<td></td>
<td>Unrealized gain on investments</td>
<td>$7,000</td>
</tr>
<tr>
<td>(2), (3)</td>
<td>Expense — house</td>
<td>9,000</td>
</tr>
<tr>
<td></td>
<td>Expense — snack bar and soda fountain</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>Expense — general and administrative</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>Accumulated depreciation - building</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>Accumulated depreciation - furniture and equipment</td>
<td>8,000</td>
</tr>
<tr>
<td>(4)</td>
<td>Expense — snack bar and soda fountain</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>Inventories</td>
<td></td>
</tr>
</tbody>
</table>

### 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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Snack bar and soda fountain sales</td>
<td>$28,000</td>
</tr>
<tr>
<td>Dues</td>
<td>20,000</td>
</tr>
<tr>
<td>Investment income</td>
<td>6,000</td>
</tr>
<tr>
<td>Bequest</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
<td><strong>59,000</strong></td>
</tr>
</tbody>
</table>

#### Expenses

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Snack bar and soda fountain</td>
<td>$32,000</td>
</tr>
<tr>
<td>House</td>
<td>26,000</td>
</tr>
<tr>
<td>General and Administrative</td>
<td>12,000</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>70,000</strong></td>
</tr>
</tbody>
</table>

- 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

AP-259
Accounting Practice

IX. Federal Taxation-Individuals, Estates, and Trusts

2M87

Answer 4 (10 points)

*a.*

Ann Ford

PROJECTED RECEIPTS AND EXPENDITURES WITH NO EFFECT ON TAXABLE INCOME

1987

<table>
<thead>
<tr>
<th>Receipts</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal income tax ($9,000 + $300 + $5,000)</td>
<td>$14,300</td>
</tr>
<tr>
<td>FICA tax ($3,132 + $215)</td>
<td>3,347</td>
</tr>
<tr>
<td>Bequest under husband's will</td>
<td>$25,000</td>
</tr>
<tr>
<td>Life insurance proceeds on husband's death</td>
<td>15,000</td>
</tr>
<tr>
<td>Food, clothing, household, and miscellaneous</td>
<td>20,000</td>
</tr>
<tr>
<td>State inheritance tax</td>
<td>2,100</td>
</tr>
<tr>
<td>City and state sales taxes</td>
<td>1,100</td>
</tr>
<tr>
<td>Auto license and registration</td>
<td>50</td>
</tr>
<tr>
<td>Political contribution</td>
<td>100</td>
</tr>
</tbody>
</table>

*b.*

Ann Ford

COMPUTATION OF PROJECTED TAXABLE INCOME

1987

Adjusted Gross Income

- Salary and commissions — outside salesperson | $50,000 |
- Salary — part-time teacher | 3,000 |
- Dividends | 500 |
- Long-term capital gain ($10,000 less $6,000) | 4,000 |
- Simple trust | 12,000 |
- Lottery winnings | 2,000 |
- Total | 71,500 |

Itemized Deductions

- Taxes
  - State income taxes ($1,800 + $1,200) | $3,000 |
  - Realty taxes | 3,600 |
- Total taxes | 6,600 |
- Contribution to church | 600 |
- Gambling losses ($420 + $480) | 900 |
- Employee business expenses ($5,000 less 2% of $71,500) | 3,570 |
- Total itemized deductions | 11,670 |

Personal Exemptions ($1,900 × 2) | 3,800 |

Taxable Income | $56,030 |

*c.*

Ann Ford

COMPUTATION OF PROJECTED FEDERAL INCOME TAX OVERPAYMENT

1987

| Tax before prepayments | $12,421 |
| Prepayments | |
| Federal income tax withheld | $9,300 |
| Estimated tax payments | 5,000 |
| Excess FICA tax | 215 |
| Amount overpaid | $ 2,094 |

AP-260
2N86
Answer 5 (10 points)

Alex and Myra Cole
TAXABLE INCOME
For the Year Ended December 31, 1985

Income
Salary $62,000
Nonmonetary remuneration (watch) 1,500
Dividends
   Gross amount $500
   Exclusion 200
Refund of state income tax 110
Capital gain (loss)
   Long-term ($3,000 minus $2,000) 1,000
   Short-term ($700 minus $900) (200)
   Excess of long-term capital gain over short-term capital loss 800
   Taxable portion 40% 320
Social security benefits
   Gross amount 9,900
   Taxable portion 50% 4,950
Total Income 69,180

Adjustments to Income
Employee business expenses (travel) 800
Adjusted Gross Income 68,380

Itemized Deductions
Medical and dental expenses
   Doctors $3,000
   Dentures 800
   Travel to doctors 100
   Medicare premiums 190
   Total 4,090
   Less: 5% of $68,380 3,419 671
Taxes
   State income tax 3,349
   Sales taxes 1,100 4,449
Contributions
   United Fund 240
   Other recognized charitable organizations 7,000 7,240
Miscellaneous
   Employee business expenses (education) 400
Total Itemized Deductions 12,760
Less: Zero bracket amount 3,540 9,200
Excess of AGI over net itemized deductions 59,160

Exemptions
   Alex 2
   Myra 1
   Ben 1 4 × $1,040 4,160
Taxable Income 55,000

AP-261
Accounting Practice

2N86
Answer 5 (cont.)

Alex and Myra Cole
COMPUTATION OF FEDERAL INCOME TAX OVERPAYMENT
For the Year Ended December 31, 1985

Tax before credit and payments on account $12,957
Political contributions credit 100
Net tax 12,857
Payments on account
Tax withheld $10,000
Estimated tax 3,000 13,000
Amount overpaid $143

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

2M86
Answer 4 (10 points)

Wolf, Inc.
WORKSHEET TO CONVERT BOOK INCOME TO TAXABLE INCOME
For the Year Ended December 31, 1985

<table>
<thead>
<tr>
<th>Revenues</th>
<th>Per books and GAAP</th>
<th>Increases</th>
<th>Decreases</th>
<th>Per tax return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>3,000,000</td>
<td></td>
<td></td>
<td>3,000,000</td>
</tr>
<tr>
<td>Equity in earnings of F &amp; W Partnership</td>
<td>60,000</td>
<td>2,000 [a]</td>
<td>58,000</td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>8,000</td>
<td>6,800 [b]</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>18,000</td>
<td>3,000 [c]</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>Gains on sale of stock</td>
<td>5,000</td>
<td>[d]</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Key-man life insurance proceeds</td>
<td>100,000</td>
<td>100,000 [e]</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Share of dividends from F &amp; W Partnership</td>
<td>10,000</td>
<td>8,500 [f]</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Net long-term capital loss</td>
<td>3,000</td>
<td>8,000 [d]</td>
<td>(5,000)</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>3,191,000</td>
<td>13,000</td>
<td>128,300</td>
<td>3,075,700</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Costs and expenses</th>
<th>Per tax return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>500,000</td>
</tr>
<tr>
<td>Doubtful accounts</td>
<td>13,000</td>
</tr>
<tr>
<td>Taxes, other than federal income</td>
<td>62,000</td>
</tr>
<tr>
<td>Interest</td>
<td>12,000</td>
</tr>
<tr>
<td>Contributions</td>
<td>50,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>60,000</td>
</tr>
<tr>
<td>Other</td>
<td>40,000</td>
</tr>
<tr>
<td>Federal income taxes</td>
<td>120,000</td>
</tr>
<tr>
<td>Totals</td>
<td>2,857,000</td>
</tr>
<tr>
<td>Net income</td>
<td>334,000</td>
</tr>
</tbody>
</table>

AP-262
Explanation of adjustments to convert book income to taxable income:

[a] Decrease in equity in earnings of F & W Partnership:

\[
\begin{array}{lcl}
\text{Dividends qualifying for exclusion} & \times 0.85 & \text{Decrease} \\
\$10,000 & \text{to} & \$2,000 \\
\text{Less net long-term capital loss} & (8,000) & \\
\text{Decrease} & \$2,000 & \\
\end{array}
\]

[f] Dividends-received deduction:

\[
\begin{array}{lcl}
\text{Dividends-received deduction} & \times 0.85 & \\
$10,000 & \text{to} & \$8,500 \\
\end{array}
\]

[g] Tax penalty is not an allowable deduction.

[h] Interest on debt incurred to carry tax-free obligations is not an allowable deduction.

[i] Decrease in deduction for contributions:

\[
\begin{array}{lcl}
\text{Taxable income before contributions} & \\
\text{Revenues} & \$3,075,700 & \\
\text{Deductions} & 2,704,000 & \\
\text{Balance} & 371,700 & \\
\text{Plus dividends-received deductions} & 15,300 & \\
\text{Total} & \$387,000 & \\
10\% \text{ allowable deduction} & \$38,700 & \\
\text{Actual contributions} & 50,000 & \\
\text{Excess not deductible in current year} & \$11,300 & \\
\end{array}
\]

[j] Life insurance premiums are not allowable as a deduction if the corporation is the beneficiary.

[k] Federal income tax expense is not an allowable deduction.
Accounting Theory

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And Unofficial Answers
Indexed To
Content Specification Outline
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<th>T-53†</th>
</tr>
</thead>
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<td>*</td>
<td></td>
</tr>
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<td>B. Conceptual Framework</td>
<td>T-1</td>
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</tr>
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<td>C. Basic Concepts and Accounting Principles</td>
<td>T-2</td>
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</tr>
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<td>D. Nature and Purpose of Basic Financial Statements</td>
<td>*</td>
<td></td>
</tr>
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<td>E. Consolidated Financial Statements</td>
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</tr>
<tr>
<td>F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts</td>
<td>T-3</td>
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</table>

<table>
<thead>
<tr>
<th>II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles</th>
<th>T-4</th>
<th>T-55†</th>
</tr>
</thead>
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<td>T-4</td>
<td></td>
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<td>B. Receivables and Accruals</td>
<td>T-6</td>
<td></td>
</tr>
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<td>C. Inventories</td>
<td>T-7</td>
<td></td>
</tr>
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<td>D. Property, Plant, and Equipment Owned or Leased</td>
<td>T-8</td>
<td></td>
</tr>
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<td>E. Intangibles and Other Assets</td>
<td>T-10</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles</th>
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<th>T-58†</th>
</tr>
</thead>
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<td>T-12</td>
<td></td>
</tr>
<tr>
<td>B. Deferred Revenues</td>
<td>T-13</td>
<td></td>
</tr>
<tr>
<td>C. Deferred Income Tax Liabilities</td>
<td>T-13</td>
<td></td>
</tr>
<tr>
<td>D. Capitalized Lease Liability</td>
<td>T-15</td>
<td></td>
</tr>
<tr>
<td>E. Bonds Payable</td>
<td>T-16</td>
<td></td>
</tr>
<tr>
<td>F. Contingent Liabilities and Commitments</td>
<td>T-17</td>
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</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles</th>
<th>T-18</th>
<th>T-61†</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Preferred and Common Stock</td>
<td>T-18</td>
<td></td>
</tr>
<tr>
<td>B. Additional Paid-in Capital</td>
<td>T-18</td>
<td></td>
</tr>
<tr>
<td>C. Retained Earnings and Dividends</td>
<td>T-18</td>
<td></td>
</tr>
<tr>
<td>D. Treasury Stock and Other Contra Accounts</td>
<td>T-19</td>
<td></td>
</tr>
<tr>
<td>E. Stock Options, Warrants, and Rights</td>
<td>T-20</td>
<td></td>
</tr>
<tr>
<td>F. Reorganization and Change in Entity</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>G. Partnerships</td>
<td>T-21</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles</th>
<th>T-22</th>
<th>T-62†</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Revenues and Gains</td>
<td>T-22</td>
<td></td>
</tr>
<tr>
<td>B. Expenses and Losses</td>
<td>T-23</td>
<td></td>
</tr>
</tbody>
</table>

* No multiple choice items were indexed for this group.
† Questions in this area are not classified according to group.
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C. Provision for Income Tax
D. Recurring Versus Nonrecurring Transactions and Events
E. Accounting Changes
F. Earnings Per Share

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Content Specification Outlines

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I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

B. Conceptual Framework

M87#1. According to the FASB conceptual framework, predictive value is an ingredient of

<table>
<thead>
<tr>
<th>Relevance</th>
<th>Reliability</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>

N86#1. According to the FASB Conceptual Framework, earnings

a. Are the same as comprehensive income.
b. Exclude certain gains and losses that are included in comprehensive income.
c. Include certain gains and losses that are excluded from comprehensive income.
d. Include certain losses that are excluded from comprehensive income.

N86#2. According to the FASB Conceptual Framework, which of the following relates to both relevance and reliability?

<table>
<thead>
<tr>
<th>Consistency</th>
<th>Verifiability</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>

M86#1. According to Statements of Financial Accounting Concepts, neutrality 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>

N85#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.

N85#2. Under Statements of Financial Accounting Concepts, comprehensive income includes which of the following?

<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. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

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>

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.

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.
### Accounting Theory

**M84#1.** Under Statement of Financial Accounting Concepts No. 2, timeliness is an ingredient of the primary quality of

- a. Reliability.
- b. Relevance.
- c. Verifiability.
- d. Representational faithfulness.

**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#1.** 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>

**M83#2.** 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>

**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?

- a. Comparability.
- b. Timeliness.
- c. Neutrality.
- d. Predictive value.

**Notes to financial statements**

<table>
<thead>
<tr>
<th>Distribution</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.

### 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.

**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. Salespersons' 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>

**M84#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.

M83#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.

E. Consolidated Financial Statements

N84#5. A subsidiary, acquired for cash in a business combination, owned inventories with a market value different than the book value as of the date of combination. A consolidated balance sheet prepared immediately after the acquisition would include this difference as part of
a. Deferred credits.
b. Goodwill.
c. Inventories.
d. Retained earnings.

N84#3. 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.

E. Consolidated Financial Statements

F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

M87#2. When purchasing power gains or losses are computed, how is each of the following classified?

<table>
<thead>
<tr>
<th>Patents</th>
<th>Unamortized premium on bonds payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Nonmonetary</td>
<td>Monetary</td>
</tr>
<tr>
<td>b. Nonmonetary</td>
<td>Nonmonetary</td>
</tr>
<tr>
<td>c. Monetary</td>
<td>Nonmonetary</td>
</tr>
<tr>
<td>d. Monetary</td>
<td>Monetary</td>
</tr>
</tbody>
</table>

N84#4. When measuring the current cost of inventories in accordance with FASB Statement No. 33, the date of sale is the

<table>
<thead>
<tr>
<th>Entry date</th>
<th>Exit date</th>
<th>End of year</th>
<th>Date of sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M86#2. During a period of inflation, an account balance remains constant. With respect to this account, a purchasing power gain will be recognized if the account is a
a. Monetary liability.
b. Monetary asset.
c. Nonmonetary liability.
d. Nonmonetary asset.

M85#4. When computing purchasing power gains or losses, how is each of the following classified?

<table>
<thead>
<tr>
<th>Allowance for doubtful accounts</th>
<th>Obligations under warranties</th>
</tr>
</thead>
<tbody>
<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>
</tbody>
</table>

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#6. 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
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.

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

A. Cash, Marketable Securities, and Investments

M87#5. A marketable equity securities portfolio is included in an unclassified balance sheet. The amount by which the aggregate cost of the marketable equity securities portfolio exceeds its aggregate market value should
   a. Be reported as a valuation allowance in the asset section of the balance sheet.
   b. Be reported as a valuation allowance in the liability section of the balance sheet.
   c. Be reported as an unrealized loss in the income statement.
   d. Not be reported in the financial statements.

M87#6. When the market value of an investment in debt securities exceeds its carrying amount, how should the asset be reported at the end of the year for each of the following?

<table>
<thead>
<tr>
<th>Short-term marketable debt securities</th>
<th>Long-term marketable debt securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Carrying amount</td>
<td>Market</td>
</tr>
<tr>
<td>b. Carrying amount</td>
<td>Carrying amount</td>
</tr>
<tr>
<td>c. Market</td>
<td>Carrying amount</td>
</tr>
<tr>
<td>d. Market</td>
<td>Market</td>
</tr>
</tbody>
</table>

M87#7. An investor purchased a bond classified as a long-term investment between interest dates at a discount. At the purchase date, the carrying amount of the bond is more than the

<table>
<thead>
<tr>
<th>Cash paid to seller</th>
<th>Face amount of bond</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>

M87#8. The market price of the common stock of an investee company increased during the year. How will the investor's investment account be affected by the increase in market price of that common stock under each of the following accounting methods?

<table>
<thead>
<tr>
<th>Cost method</th>
<th>Equity method</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>

M86#14. A company has a marketable equity securities portfolio. The aggregate market value exceeds the aggregate cost. This difference should
   a. Be accounted for as a valuation allowance in the asset section of the balance sheet.
   b. Be accounted for separately in the shareholders' equity section of the balance sheet.
   c. Be accounted for as an unrealized gain in the income statement.
   d. Not be accounted for in the financial statements.

M86#15. An investor uses the cost method to account for investments in common stock. Dividends received in excess of the investor's share of investee's earnings subsequent to the date of investment
   a. Do not affect the investment account.
   b. Decrease the investment account.
   c. Increase the investment account.
   d. Increase the investment revenue account.

M86#3. A short-term marketable debt security was purchased on September 1, 1985, between interest dates. The next interest payment date was February 1, 1986. Because of a permanent decline in market value, the cost of the debt security substantially exceeded its
market value at December 31, 1985. On the balance sheet at December 31, 1985, the debt security should be carried at
a. Cost.
b. Cost plus the accrued interest paid.
c. Market value.
d. Market value plus the accrued interest paid.

M86#4. The valuation allowance for a marketable equity securities portfolio included in current assets should be a component of
b. Noncurrent liabilities.
c. Noncurrent assets.
d. Current assets.

M86#5. 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 highest if the bond was purchased at
a. Par.
b. Face value.
c. A discount.
d. A premium.

M86#6. How will the investor’s investment account be affected by the investor’s share of the earnings of the investee after the date of acquisition under each of the following accounting methods?

<table>
<thead>
<tr>
<th>Cost method</th>
<th>Equity method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>Increase</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>No effect</td>
</tr>
</tbody>
</table>

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. Increases the goodwill account.
c. Increases the investment revenue account.
d. Does not affect the investment account.

M85#6. An investor purchased a bond classified as a long-term investment between interest dates at a pre-

Selected Questions

Cash paid to seller | Face value of bond
<table>
<thead>
<tr>
<th></th>
<th></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#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.

M83#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?

Cost method | Equity method
<table>
<thead>
<tr>
<th></th>
<th></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>

M83#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.

M83#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.

M83#13. 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.
Accounting Theory

B. Receivables and Accruals

M87#3. On July 1, 1986, 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, 1987. The interest receivable account would show a balance on

M87#4. When the allowance method of recognizing bad debt expense is used, the allowance for doubtful accounts would decrease when a(an)
   a. Specific account receivable is collected.
   b. Account previously written off is collected.
   c. Account previously written off becomes collectible.
   d. Specific uncollectible account is written off.

M86#7. A 90-day 15% interest-bearing note receivable is sold to a bank with recourse after being held for 60 days. The proceeds are calculated using an 18% interest rate. The amount credited to notes receivable at the date of the discounting transaction would be
   a. The same as the cash proceeds.
   b. Less than the face value of the note.
   c. The face value of the note.
   d. The maturity value of the note.

M86#8. 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. Decrease the allowance for doubtful accounts.
   c. Have no effect on the allowance for doubtful accounts.
   d. Increase the allowance for doubtful accounts.

M85#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.

M84#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 June 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.

M84#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>

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.

M83#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>
Selected Questions

M83#11. On July 1 of this year, 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 of next year. At December 31 of this year, the company should report in its balance sheet
   a. A deferred credit for interest applicable to next year.
   b. No interest receivable.
   c. Interest receivable for the entire amount of the interest due on June 30 of next year.
   d. Interest receivable for the interest accruing this year.

M83#12. A method of estimating bad debts that focuses on the income statement rather than the balance sheet is the allowance method based on
   a. Direct write off.
   b. Aging the trade receivable accounts.
   c. Credit sales.
   d. The balance in the trade receivable accounts.

C. Inventories

M86#5. Theoretically, warehousing costs incurred by the consignor before consigned goods are transferred to the consignee should be considered
   a. An expense by the consignor.
   b. An expense by the consignee.
   c. Inventoriable by the consignor.
   d. Inventoriable by the consignee.

M86#6. The dollar-value LIFO inventory cost flow method involves computations based on

<table>
<thead>
<tr>
<th>Inventory pools of similar items</th>
<th>A specific price index for each year</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M86#7. 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. Original cost.
   b. Replacement cost.
   c. Net realizable value.
   d. Net realizable value less the normal profit margin.

M86#8. The original cost of an inventory item is above the replacement cost and below the net realizable value. The net realizable value less the normal profit margin is above the replacement cost and the original cost. Using 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.

M86#10. Theoretically, cash discounts permitted on purchased raw materials should be
   a. Added to other income, whether taken or not.
   b. Added to other income, only if taken.
   c. Deducted from inventory, whether taken or not.
   d. Deducted from inventory, only if taken.

M86#11. The weighted average for the year 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.</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
</tr>
</tbody>
</table>

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?

<table>
<thead>
<tr>
<th>Ending inventory at current year cost</th>
<th>Ending inventory at base year cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Numerator</td>
<td>Denominator</td>
</tr>
<tr>
<td>b. Numerator</td>
<td>Not Used</td>
</tr>
<tr>
<td>c. Denominator</td>
<td>Numerator</td>
</tr>
<tr>
<td>d. Not Used</td>
<td>Denominator</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.
Accounting Theory

N84#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>

N84#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

N83#9. From a theoretical viewpoint, which of the following costs would be considered inventoriable?

<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

D. Property, Plant, and Equipment Owned or Leased

N86#8. An expenditure subsequent to acquisition of assembly-line manufacturing equipment benefits future periods. The expenditure should be capitalized if it is a

<table>
<thead>
<tr>
<th>Betterment</th>
<th>Rearrangement</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>

N86#9. A machine with a four-year estimated useful life and an estimated 15% salvage value was acquired on January 1, 1984. The increase in accumulated depreciation for 1985 using the double-declining-balance method would be

- a. Original cost × 85% × 50%
- b. Original cost × 50%
- c. Original cost × 85% × 50% × 50%
- d. Original cost × 50% × 50%

N86#10. Theoretically, which of the following costs incurred in connection with a machine purchased for use in a company’s manufacturing operations would be capitalized?

<table>
<thead>
<tr>
<th>Insurance on machine while in transit</th>
<th>Testing and preparation of machine for use</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>

M86#17. An asset is being constructed for an enterprise’s own use. The asset has been financed with a specific new borrowing. The interest cost incurred during the construction period as a result of expenditures for the asset is

- a. Interest expense in the construction period.
- b. A prepaid asset to be written off over the estimated useful life of the asset.
- c. A part of the historical cost of acquiring the asset to be written off over the estimated useful life of the asset.
- d. A part of the historical cost of acquiring the asset to be written off over the term of the borrowing used to finance the construction of the asset.

M86#18. A depreciable asset has an estimated 15% salvage value. At the end of its estimated useful life, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

<table>
<thead>
<tr>
<th>Straight-line</th>
<th>Productive output</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>

M86#19. The lessee should amortize the capitalizable cost of the leased asset in a manner consistent with the lessee’s normal depreciation policy for owned assets for leases that

<table>
<thead>
<tr>
<th>Contain a bargain purchase option</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
</tr>
<tr>
<td>b. No</td>
</tr>
<tr>
<td>c. Yes</td>
</tr>
<tr>
<td>d. Yes</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Transfer ownership of the property to the lessee by the end of the lease term</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
</tr>
<tr>
<td>b. No</td>
</tr>
<tr>
<td>c. Yes</td>
</tr>
<tr>
<td>d. Yes</td>
</tr>
</tbody>
</table>

M86#20. A lessee incurred landscaping costs to improve leased property. The estimated useful life of the landscaping costs is six years. The remaining term of
the nonrenewable lease is five years. The landscaping costs should be
a. Capitalized as leasehold improvements and depreciated over five years.
b. Capitalized as leasehold improvements and depreciated over six years.
c. Expensed as incurred and included with rent expense.
d. Expensed as incurred but not included with rent expense.

M86#21. A company using the composite depreciation method for its fleet of trucks, cars, and campers retired one of its trucks due to damage before the average service life of the composite group was reached. An insurance recovery was received. Net book value of these composite asset accounts would be decreased by the
a. Insurance recovery received.
b. Insurance recovery received less depreciation on the truck to the date of retirement.
c. Original cost of the truck less the insurance recovery received.
d. Original cost of the truck.

M85#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.

M85#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.

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 10/15.
b. Original cost multiplied by 10/15.
c. Original cost multiplied by 10/15 less total salvage value.
d. (Original cost less salvage value) multiplied by 10/15.

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.
c. Original cost of the truck less depreciation on the truck to the date of retirement.
d. Insurance recovery received.

M84#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 expensed as incurred.
c. Deducted from the cost of the plant.
d. Deducted from the cost of the land.

M84#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.

M84#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</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>depreciation</td>
<td>depreciation</td>
</tr>
<tr>
<td>a.</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#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 (an)
  a. Asset and a liability.
  b. Asset but not a liability.
  c. Neither an asset nor a liability.
  d. Expense.

M84#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
  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 installation 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 purchase 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 annuity 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 depreciation 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, excluding that portion of the payments representing executory 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.

E. Intangibles and Other Assets

M87#9. The premium on a three-year insurance policy expiring on December 31, 1988, was paid in total on January 1, 1986. The original payment was initially debited to a prepaid asset account. The appropriate jour-
Selected Questions

N86#11. Which of the following costs of internally generated goodwill inherent in a continuing business and related to an enterprise as a whole should be capitalized and then amortized over their estimated useful lives?

<table>
<thead>
<tr>
<th>Costs of maintaining goodwill</th>
<th>Costs of restoring goodwill</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. 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.

M85#12. On January 1, 1980, an intangible asset with a fifty-year estimated useful life was acquired. On January 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, allocated equally over a forty-year life.
d. The unamortized cost on January 1, 1985, allocated equally over a thirty-year life.

N86#18. Which of the following amounts incurred in connection with a trademark should be capitalized?

<table>
<thead>
<tr>
<th>Cost of a successful defense</th>
<th>Registration fees</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>

N86#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.

T-11
Accounting Theory

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?

<table>
<thead>
<tr>
<th></th>
<th>Legal fees</th>
<th>Registration fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
<td>No</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>

M83#18. Which of the following assets acquired in 1983 are amortizable?

<table>
<thead>
<tr>
<th></th>
<th>Goodwill</th>
<th>Trademarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

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></th>
<th>Prepaid assets</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No change</td>
<td>Increase</td>
</tr>
<tr>
<td>b.</td>
<td>No change</td>
<td>No change</td>
</tr>
<tr>
<td>c.</td>
<td>Decrease</td>
<td>No change</td>
</tr>
<tr>
<td>d.</td>
<td>Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

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

A. Payables and Accruals

M87#10. A company borrowed cash from a bank and issued to the bank a short-term noninterest-bearing note payable. The bank discounted the note at 10% and remitted the proceeds to the company. The effective interest rate paid by the company in this transaction would be

<table>
<thead>
<tr>
<th></th>
<th>Periodic payment of interest</th>
<th>Secured by collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
<td>No</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>

N86#16. Which of the following is generally associated with payables classified as accounts payable?

<table>
<thead>
<tr>
<th></th>
<th>Liability for federal unemployment taxes</th>
<th>Liability for employer’s share of FICA taxes</th>
<th>A customer</th>
<th>An employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

M86#13. A returnable cash deposit should be classified by the company as a liability when the deposit is received from

<table>
<thead>
<tr>
<th></th>
<th>A customer</th>
<th>An employee</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>
Selected Questions

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#21. Rent collected in advance by the lessor for an operating lease is a(an)

a. Deferred revenue.
b. Accrued revenue.
c. Accrued liability.
d. Deferred asset.

M84#16. Office supplies were ordered by Dwyer Company from Orcutt Company on December 15, 1983. The terms of sale were FOB destination. Orcutt shipped the office supplies on December 28, 1983 and Dwyer received them on January 3, 1984. When should Dwyer record the account payable?


M84#17. On September 1, 1982, a company borrowed cash and signed a two-year interest-bearing note on which both the principal and interest are payable on September 1, 1984. At December 31, 1983, the liability for accrued interest should be

a. Zero.
b. For 4 months of interest.
c. For 12 months of interest.
d. For 16 months of interest.

M83#13. The issuer of a 10-year term bond sold at par three years ago with interest payable May 1 and November 1 each year, should report on its December 31 balance sheet a (an)

a. Liability for accrued interest.
b. Addition to bonds payable.
c. Increase in deferred charges.
d. Contingent liability.

M83#21. When a company receives a deposit from a customer to protect itself against nonpayment for future services, the deposit should be classified by the company as

a. Revenue.
b. A liability.
c. Part of the allowance for doubtful accounts.
d. A deferred credit deducted from accounts receivable.

B. Deferred Revenues

M87#12. A retail store received cash and issued gift certificates that are redeemable in merchandise. The gift certificates lapse one year after they are issued. How would the deferred revenue account be affected by each of the following transactions?

<table>
<thead>
<tr>
<th>Redemption of certificates</th>
<th>Lapse of certificates</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M85#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.

C. Deferred Income Tax Liabilities

M87#15. At the most recent year end, a company had a deferred income tax credit related to a noncurrent asset that exceeded a deferred income tax charge related to a current liability. Which of the following should be reported in the company’s most recent year-end balance sheet?

a. The excess of the deferred income tax credit over the deferred income tax charge as a non-current liability.
b. The excess of the deferred income tax credit over the deferred income tax charge as a current liability.
c. The deferred income tax credit as a non-current liability.
d. The deferred income tax credit as a current liability.
Accounting Theory

N86#12. A company with an effective income tax rate of 40% should report in its balance sheet a noncurrent deferred income tax credit for:

a. The total amount of the excess of accumulated depreciation for financial statement purposes over accumulated depreciation for income tax purposes.
b. 40% of the excess of accumulated depreciation for financial statement purposes over accumulated depreciation for income tax purposes.
c. The total amount of the excess of accumulated depreciation for income tax purposes over accumulated depreciation for financial statement purposes.
d. 40% of the excess of accumulated depreciation for income tax purposes over accumulated depreciation for financial statement purposes.

N86#13. At the most recent year end, a company had a deferred income tax credit related to a current asset that exceeded a deferred income tax charge related to a current liability, and a deferred income tax credit related to a noncurrent asset. Which of the following should be reported in the company's most recent year-end balance sheet?

a. The sum of the two deferred income tax credits as a noncurrent liability.
b. The excess of the two deferred income tax credits over the deferred income tax charge as a current liability.
c. The excess of the deferred income tax credit related to a current asset over the deferred income tax charge related to a current liability as a current liability.
d. The deferred income tax charge as a current asset.

N86#10. A machine was purchased in 1984. The straight-line depreciation method was 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.

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?

a. Current deferred income tax credit.
b. Noncurrent deferred income tax credit.
c. Current deferred income tax debit.
d. Noncurrent deferred income tax debit.

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. 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 pur-
poses 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**

**M87#13.** A six-year capital lease specifies equal minimum annual lease payments. Part of this payment represents interest and part represents a reduction in the net lease liability. The portion of the minimum lease payment in the fourth year applicable to the reduction of the net lease liability should be
a. The same as in the third year.
b. Less than in the third year.
c. Less than in the fifth year.
d. More than in the fifth year.

**M87#14.** Lease Y does not contain a bargain purchase option, but the lease term is equal to 90 percent of the estimated economic life of the leased property. Lease Z does not transfer ownership of the property to the lessee by the end of the lease term, but the lease term is equal to 75 percent of the estimated economic life of the leased property. How should the lessee classify these leases?

<table>
<thead>
<tr>
<th>Lease Y</th>
<th>Lease Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Capital lease</td>
<td>Operating lease</td>
</tr>
<tr>
<td>b. Capital lease</td>
<td>Capital lease</td>
</tr>
<tr>
<td>c. Operating lease</td>
<td>Capital lease</td>
</tr>
<tr>
<td>d. Operating lease</td>
<td>Operating lease</td>
</tr>
</tbody>
</table>

**M86#26.** Lease Y contains a bargain purchase option and the lease term is equal to 75 percent of the estimated economic life of the leased property. Lease Z contains a bargain purchase option and the lease term is equal to less than 75 percent of the estimated economic life of the leased property. How should the lessee classify these leases?

<table>
<thead>
<tr>
<th>Lease Y</th>
<th>Lease Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Operating lease</td>
<td>Operating lease</td>
</tr>
<tr>
<td>b. Operating lease</td>
<td>Capital lease</td>
</tr>
<tr>
<td>c. Capital lease</td>
<td>Capital lease</td>
</tr>
<tr>
<td>d. Capital lease</td>
<td>Operating lease</td>
</tr>
</tbody>
</table>

**M86#27.** A six-year capital lease entered into on December 31, 1985, minimum annual lease payment consists of which of the following?

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>Lease liability</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>

**M85#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.

**M84#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.
E. Bonds Payable

M87#16. The market price of a bond issued at a discount is the present value of its principal amount at the market (effective) rate of interest:
   a. Plus the present value of all future interest payments at the market (effective) rate of interest.
   b. Plus the present value of all future interest payments at the rate of interest stated on the bond.
   c. Less the present value of all future interest payments at the market (effective) rate of interest.
   d. Less the present value of all future interest payments at the rate of interest stated on the bond.

M87#17. A five-year term bond was issued by a company on January 1, 1985, at a premium. The carrying amount of the bond at December 31, 1986, would be:
   a. The same as the carrying amount at January 1, 1985.
   c. Lower than the carrying amount at December 31, 1985.
   d. Lower than the carrying amount at December 31, 1985.

M87#18. The proceeds from a bond issued with detachable stock purchase warrants should be accounted for:
   a. Entirely as bonds payable.
   b. Entirely as stockholders' equity.
   c. Partially as unearned revenue, and partially as bonds payable.
   d. Partially as stockholders' equity, and partially as bonds payable.

N85#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.

N85#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>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N85#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>
</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>

N85#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.
Selected Questions

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 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>

N84#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.

N84#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>

N84#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>

N84#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</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.

F. Contingent Liabilities and Commitments

M83#15. A safety hazard exists for a manufactured product. Occurrence of the loss is reasonably possible and the amount of the loss can be reasonably estimated. This loss contingency should be

<table>
<thead>
<tr>
<th>Accrued</th>
<th>Disclosed</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>

M86#28. Which of the following contingencies should generally be accrued on the balance sheet as a liability when the occurrence of the contingent event is reasonably possible and its amount can be reasonably estimated?

<table>
<thead>
<tr>
<th>Expropriation of assets</th>
<th>Product warranty obligation</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>
Accounting Theory

N85#19. Which of the following contingencies should generally be accrued on the balance sheet when the occurrence of the contingent event is reasonable 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>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

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>

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.

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

A. Preferred and Common Stock

N86#20. The issuance of shares of preferred stock to shareholders

a. Increases preferred stock outstanding.
b. Has no effect on preferred stock outstanding.
c. Increases preferred stock authorized.
d. Decreases preferred stock authorized.

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.

B. Additional Paid-in Capital

M86#29. On February 1, 1986, authorized common stock was sold on a subscription basis at a price in excess of par value, and 20% of the subscription price was collected. On May 1, 1986, the remaining 80% of the subscription price was collected. Additional paid-in capital would increase on

<table>
<thead>
<tr>
<th>February 1, 1986</th>
<th>May 1, 1986</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>

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

Common stock | Preferred stock |
<table>
<thead>
<tr>
<th></th>
<th></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>

C. Retained Earnings and Dividends

M87#20. A company declared a cash dividend on its common stock in December 1986, payable in January 1987. Retained earnings would

a. Increase on the date of declaration.
b. Not be affected on the date of declaration.
c. Not be affected on the date of payment.
d. Decrease on the date of payment.
Selected Questions

M87#21. How would retained earnings be affected by the declaration of each of the following?

<table>
<thead>
<tr>
<th>Stock dividend</th>
<th>Stock split</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M85#17. How would a stock split affect each of the following?

<table>
<thead>
<tr>
<th>Total stockholders' equity</th>
<th>Additional paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>a. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>b. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>c. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

M86#21. 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.

M84#22. How would total stockholders’ equity be affected by the declaration of each of the following?

<table>
<thead>
<tr>
<th>Stock dividend</th>
<th>Stock split</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M84#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>

M86#14. When a property dividend is declared and the book value of the property exceeds its market value, the dividend is recorded at the

a. Market value of the property at the date of distribution.
b. Market value of the property at the date of declaration.
c. Book value of the property at the date of declaration.
d. Book value of the property at the date of distribution if it still exceeds the market value of the property at the date of declaration.

M86#15. 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>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>

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.
c. Loss on disposal of a segment of a business.
d. Extraordinary item.

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

a. 10 percent stock dividend.
b. 2 for 1 stock split.
c. Employee stock bonus.
d. Pooling of interests.

D. Treasury Stock and Other Contra Accounts

M87#33. Five thousand (5,000) shares of common stock with a par value of $10 per share were issued initially at $12 per share. Subsequently, one thousand
(1,000) of these shares were acquired as treasury stock at $15 per share. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect of the acquisition 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. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

N86#23. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently sold for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect on total stockholders’ equity?

<table>
<thead>
<tr>
<th>Purchase of treasury stock</th>
<th>Sale of treasury stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

N86#31. 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 of the subsequent sale 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. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>c. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>Increase</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.

E. Stock Options, Warrants, and Rights

M87#34. A company issued rights to its existing shareholders to purchase, for $30 per share, unissued shares
Selected Questions

of $15 par value common stock. Additional paid-in capital will be credited when the

<table>
<thead>
<tr>
<th>Rights are issued</th>
<th>Rights lapse</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</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>

N86#26. A company issued rights to its existing shareholders to purchase shares of common stock. When the rights are exercised, additional paid-in capital would be credited if the purchase price
a. Exceeded the par value.
b. Was the same as the par value.
c. Was the same as the par value, but less than the market value at the date of exercise.
d. Was less than the par value.

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.

N84#30. A company issued rights to its existing shareholders to purchase for $30 per share, 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.

M83#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.

G. Partnerships

M87#35. When Dubke retired from the partnership of Dubke, Logan and Flaherty, the final settlement of Dubke’s partnership interest exceeded Dubke’s capital balance. Under the bonus method, the excess
a. Was recorded as goodwill.
b. Was recorded as an expense.
c. Had no effect on the capital balances of Logan and Flaherty.
d. Reduced the capital balances of Logan and Flaherty.

M86#32. A partnership is formed by two individuals who were previously sole proprietors. Property other than cash which is part of the initial investment in the partnership would be recorded for financial accounting purposes at the
a. Proprietors’ book values or the fair value of the property at the date of the investment, whichever is higher.
b. Proprietors’ book values or the fair value of the property at the date of the investment, whichever is lower.
c. Proprietors’ book values of the property at the date of the investment.
d. Fair value of the property at the date of the investment.

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.
Accounting Theory

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

M87#26. A company uses the percentage-of-completion method to account for a four-year construction contract. Progress billings sent in the second year that were collected in the third year would
a. Not be included in the calculation of the income recognized in the second, third, or fourth year.
b. Be included in the calculation of the income recognized in the second year.
c. Be included in the calculation of the income recognized in the third year.
d. Be included in the calculation of the income recognized in the fourth year.

M87#27. A lease 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 two components of the gross investment (the net receivable) should be
a. Amortized over the period of the lease as interest revenue using the interest method.
b. Amortized over the period of the lease as interest revenue using the straight-line method.
c. Recognized in full as interest revenue at the lease's inception.
d. Recognized in full as manufacturer's or dealer's profit at the lease's inception.

N86#24. 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
a. Translation gain reported as a separate component of stockholders' equity.
b. Translation gain reported as a component of income from continuing operations.
c. Transaction gain reported as a separate component of stockholders' equity.
d. Transaction gain reported as a component of income from continuing operations.

N86#25. A company uses the percentage-of-completion method to account for a four-year construction contract. Which of the following would be used in the calculation of the income recognized in the first year?

<table>
<thead>
<tr>
<th>Progress billings</th>
<th>Collections on progress billings</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>

M86#33. 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 interest method.
d. Should be amortized over the period of the lease using the straight-line method.

N85#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>
</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>

N85#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 (an)
- a. Separate component of stockholders' equity.
- b. Deferred credit.
- c. Component of income from continuing operations.
- d. Extraordinary item.

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#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.
Selected Questions

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#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.

B. Expenses and Losses

M87#22. When the interest payment dates of a bond are May 1 and November 1, and the bond is issued on June 1, 1986, the amount of interest expense for the year ended December 31, 1986, would be for
   a. Two months.
   b. Six months.
   c. Seven months.
   d. Eight months.

M87#23. Which of the following components should be included in the calculation of net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan?

<table>
<thead>
<tr>
<th>Actual return on plan assets, if any</th>
<th>Amortization of unrecognized prior service cost, if any</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>

M87#24. A December 15, 1986, purchase of goods was denominated in a currency other than the entity’s functional currency. The transaction resulted in a payable that was fixed in terms of the amount of foreign currency, and was paid on the settlement date, January 20, 1987. The exchange rates between the functional currency and the currency in which the transaction was denominated changed at December 31, 1986, resulting in a loss that should
   a. Not be reported until January 20, 1987, the settlement date.
   b. Be included as a separate component of stockholders’ equity at December 31, 1986.
   c. Be included as a deferred charge at December 31, 1986.
   d. Be included as a component of income from continuing operations for 1986.

M87#25. A material loss should be presented separately as a component of income from continuing operations when it is
   a. Infrequent in occurrence and unusual in nature.
   b. Infrequent in occurrence but not unusual in nature.
   c. A cumulative effect-type change in accounting principle.
   d. An extraordinary item.
N86#27. Which of the following utilizes the straight-line depreciation method?

<table>
<thead>
<tr>
<th>Composite depreciation</th>
<th>Group depreciation</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>

M86#34. A purchase of goods, denominated in a currency other than the entity's functional currency, resulted in a payable that was fixed in terms of the amount of foreign currency that would be paid. Exchange rates between the functional currency and the currency in which the transaction was denominated changed. The resulting loss should be included as a (an)

a. Component of income from continuing operations.
b. Separate component of stockholders' equity.
c. Deferred asset.
d. Extraordinary item.

N85#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.

N85#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.

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>1983</th>
<th>1984</th>
<th>1985</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>Yes</td>
</tr>
<tr>
<td>d. 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.

M84#27. Losses resulting from the process of translating a foreign entity's financial statements from the functional currency, which is experiencing a 3% inflation rate, to U.S. dollars should be included as a (an)

a. Deferred charge.
b. Separate component of stockholders' equity.
c. Component of income from continuing operations.
d. Extraordinary item.

M83#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.

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
Selected Questions

M83#34. When equipment held under an operating lease is subleased by the original lessee, the original lessee would account for the sublease as a (an)
   a. Operating lease.
   b. Sales-type lease.
   c. Direct financing lease.
   d. Capital lease.

C. Provision for Income Tax

M87#31. The deferred method of tax allocation should be used for

<table>
<thead>
<tr>
<th>Permanent differences</th>
<th>Timing differences</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>

N86#28. Timing differences affect

<table>
<thead>
<tr>
<th>Interperiod income tax allocation</th>
<th>Intraperiod income tax allocation</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>

M86#30. Interperiod income tax allocation should be used for

<table>
<thead>
<tr>
<th>Permanent differences</th>
<th>Timing differences</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>

N86#28. The deferred method of tax allocation should be followed for

<table>
<thead>
<tr>
<th>Interperiod income tax allocation</th>
<th>Intraperiod income tax allocation</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>

N86#28. The deferred method of 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>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

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>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

D. Recurring Versus Nonrecurring Transactions and Events

N86#31. When a segment of a business has been discontinued during the year, the loss on disposal should
   a. Include operating losses of the current period up to the measurement date.
   b. Include operating losses during the phase-out period.
   c. Exclude employee relocation costs associated with the decision to dispose.
   d. Exclude severance pay associated with the decision to dispose.

N86#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.

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.

N86#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.
Accounting Theory

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.

E. Accounting Changes

N85#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.

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.

F. Earnings Per Share

M87#32. In determining primary earnings per share, a common stock equivalent was antidilutive in 1985 and dilutive in 1986. The common stock equivalent would be included in the computation for

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N85#25. Antidilutive common stock equivalents would generally be used in the calculation of

Primary earnings per share | Fully diluted earnings per share
a. Yes | Yes
b. Yes | No
c. No | Yes
d. No | No

N84#37. 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.

M84#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.
Selected Questions

VI. Other Financial Topics

A. Statement of Changes in Financial Position

M87#28. In a statement of changes in financial position prepared on a cash basis (indirect method) an increase in inventories should be presented as a(n)
   a. Outflow of cash.
   b. Inflow and outflow of cash.
   c. Addition to income from continuing operations.
   d. Deduction from income from continuing operations.

M87#29. Which of the following should be presented in a statement of changes in financial position prepared on a cash basis?

<table>
<thead>
<tr>
<th>Stock dividend</th>
<th>Stock split</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>

M86#29. A company declared a property dividend to be paid by distributing inventory. The fair value of the inventory is the same as its carrying value. In a statement of changes in financial position prepared on a working capital basis, this transaction should be presented as a(n)
   a. Addition to income from continuing operations.
   b. Deduction from income from continuing operations.
   c. Source and a use of funds.
   d. Use of funds.

M86#30. A loss on the sale of a long-term investment should be presented in a statement of changes in financial position as a(n)
   a. Addition to income from continuing operations.
   b. Deduction from income from continuing operations.
   c. Source and a use of funds.
   d. Use of funds.

M86#24. A stock split-up should 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>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>

M86#25. Deferred income tax expense resulting from timing differences related to depreciation of plant assets 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. Deduction from income from continuing operations.
   d. Addition to income from continuing operations.

N85#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>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N85#27. The amortization of bond premium on long-term debt should be presented in a statement of changes in financial position as a (an)
   a. Use of funds.
   b. Source and a use of funds.
   c. Deduction from income from continuing operations.
   d. Addition to income from continuing operations.

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.
**Accounting Theory**

**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 a (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#38.** 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.

**B. Accounting Policies**

**M86#36.** Which of the following facts concerning inventories should be disclosed in the Summary of Significant Accounting Policies?

<table>
<thead>
<tr>
<th>Composition</th>
<th>Pricing</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>

**N85#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>

**C. Accounting Changes**

**M87#30.** When a company changes the expected service life of an asset because additional information has been obtained, 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. 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>

**N86#36.** Pro forma effects on net income and earnings per share of retroactive application would usually be reported on the face of the income statement for a

<table>
<thead>
<tr>
<th>Change in accounting entity</th>
<th>Change in accounting estimate</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>

**N85#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.
Selected Questions

M85#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.

M84#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

<table>
<thead>
<tr>
<th>Change in accounting principle</th>
<th>Change in accounting entity</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#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.

M83#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.

D. Nonmonetary Transactions

M87#36. An investment in marketable securities was accounted for by the cost method. These securities were distributed to stockholders as a property dividend in a nonreciprocal transfer. The dividend should be reported at the

a. Fair value of the asset transferred.
b. Fair value of the asset transferred or the recorded amount of the asset transferred, whichever is higher.
c. Fair value of the asset transferred or the recorded amount of the asset transferred, whichever is lower.
d. Recorded amount of the asset transferred.

N86#33. Company A and Company B exchanged nonmonetary assets with monetary consideration involved. The exchange did not culminate an earning process for either Company A or Company B. The recipient of the monetary consideration has

a. Realized gain on the exchange to the extent of the monetary consideration received.
b. Realized gain on the exchange to the extent that the amount of the monetary consideration received exceeds the recorded amount of the asset surrendered.
c. Realized gain on the exchange to the extent that the amount of the monetary consideration received exceeds a proportionate share of the recorded amount of the asset surrendered.
d. No realized gain on the exchange.

M86#35. A nonmonetary asset received by Company Y in a nonreciprocal transfer from Company Z should be recorded by Y at

a. Z's recorded amount.
b. Z's recorded amount or the fair value of the asset received, whichever is higher.
c. Z's recorded amount or the fair value of the asset received, whichever is lower.
d. The fair value of the asset received.

E. Business Combinations

N86#34. In a business combination, costs of registering equity securities are a reduction of the otherwise determinable fair value of the securities for a

<table>
<thead>
<tr>
<th>Pooling of interests</th>
<th>Purchase</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>
N85#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>
</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>

N85#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>

F. Interim Financial Statements

M87#36. An inventory loss from a market price decline occurred in the first quarter. The loss was not expected to be restored in the fiscal year. However, in the third quarter the inventory had a market price recovery that exceeded the market decline that occurred in the first quarter. For interim financial reporting, the dollar amount of net inventory should be

a. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of the market price recovery.
b. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of decrease in the first quarter.
c. Not be affected in the first quarter and increase in the third quarter by the amount of the market price recovery that exceeded the amount of the market price decline.
d. Not be affected in either the first quarter or the third quarter.

M86#35. For interim financial reporting, which of the following may be accrued or deferred to provide an appropriate cost in each period?

<table>
<thead>
<tr>
<th>Property taxes</th>
<th>Rent</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>

M86#37. The accrual or deferral of interest costs to allocate cost to each period is appropriate for

<table>
<thead>
<tr>
<th>Interim financial reporting</th>
<th>Year-end financial reporting</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

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>

c. Equity in income from unconsolidated subsidiaries.
d. Extraordinary items.

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 capital gains and investment tax credits.

<table>
<thead>
<tr>
<th>Capital gains</th>
<th>Investment tax credits</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>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>

II. Segments and Lines of Business

N86#37. In financial reporting for segments of a business enterprise, the operating profit or loss of a manufacturing segment should include

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>Income taxes</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>

M86#38. In financial reporting for segments of a business enterprise, the revenue of a segment should include

a. Intersegment sales of services similar to those sold to unaffiliated customers.
b. Intersegment billings for the cost of shared facilities.

M85#33. In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include

Expenses related to revenue from intersegment sales | Portion of general corporate expenses
---|---
| a. Yes | Yes |
| b. Yes | No  |
| c. No  | No  |
| d. No  | Yes |

M86#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.

M63#44. In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include

Reasonably allocated common operating costs | Traceable operating costs
---|---
| a. No | No |
| b. No | Yes|
| c. Yes| No |
| d. Yes| Yes|
 Accounting Theory

I. Employee Benefits

M87#39. An employer sponsoring a defined benefit pension plan should disclose the

<table>
<thead>
<tr>
<th>Amount of unrecognized prior service cost</th>
<th>Fair value of plan 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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N86#38. If the payment of compensation is probable, the amount can be reasonably estimated, and the obligation relates to rights that vest, employees’ compensation for future absences should be

a. Accrued if attributable to employees’ services already rendered.
b. Accrued if attributable to employees’ services not already rendered.
c. Accrued if attributable to employees’ services whether already rendered or not.
d. Recognized when paid.

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>

J. Analysis of Financial Statements

M87#40. 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. Denominator</td>
<td>Not used</td>
</tr>
<tr>
<td>d. Denominator</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

N86#39. How are each of the following used in the calculation of the receivable turnover?

<table>
<thead>
<tr>
<th>Cash sales</th>
<th>Credit sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Not used</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Not used</td>
<td>Denominator</td>
</tr>
<tr>
<td>c. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>d. Denominator</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

M86#39. 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. Not used</td>
<td>Denominator</td>
</tr>
<tr>
<td>b. Not used</td>
<td>Numerator</td>
</tr>
<tr>
<td>c. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>d. Numerator</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

N84#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>

M83#45. Inventories would be included in the calculation of which of the following?

<table>
<thead>
<tr>
<th>Acid test (quick) ratio</th>
<th>Working capital (current) ratio</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>

K. Development Stage Enterprises

M87#37. A development stage enterprise

a. Issues an income statement that is the same as an established operating enterprise, and shows cumulative amounts from the enterprise’s inception as additional information.
b. Issues an income statement that is the same as an established operating enterprise, but does not show cumulative amounts from the enterprise’s inception as additional information.
c. Issues an income statement that only shows cumulative amounts from the enterprise’s inception.
d. Does not issue an income statement.

N85#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>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
L. Personal Financial Statements

**N86#40.** Personal financial statements consist of a statement of financial condition and usually (an)

<table>
<thead>
<tr>
<th>Income statement</th>
<th>Statement of changes in net worth</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#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#41.** 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. Estimated direct labor hours.
b. Actual direct labor hours.
c. Estimated factory overhead.
d. Actual factory overhead.

**N86#41.** Prime cost and conversion cost share what common element of total cost?

a. Direct labor.
b. Direct materials.
c. Variable overhead.
d. Fixed overhead.

**M85#41.** Wages paid to a timekeeper in a factory are a

<table>
<thead>
<tr>
<th>Prime cost</th>
<th>Conversion 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>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**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#48.** Indirect labor is a

a. Nonmanufacturing cost.
b. Conversion cost.
c. Prime cost.
d. Period cost.

**M84#37.** Which of the following is an element of prime cost?

<table>
<thead>
<tr>
<th>Direct materials</th>
<th>Indirect materials</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#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>
**Accounting Theory**

**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.

**N83#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>

**B. Process and Job Order Costing**

**N87#42.** In a job order cost system, direct labor costs usually are recorded initially as an increase in

a. Factory overhead applied.
b. Factory overhead control.
c. Finished goods control.
d. Work in process control.

**N86#42.** Costs are accumulated by responsibility center for control purposes when using

<table>
<thead>
<tr>
<th>Job order costing</th>
<th>Process costing</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>

**N86#42.** 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 plus cost of beginning work in process inventory.
d. Current costs less cost of beginning work in process inventory.

**N85#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.

**N85#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.

**N85#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
Selected Questions

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</th>
<th>Ending work</th>
</tr>
</thead>
<tbody>
<tr>
<td>in process inventory</td>
<td>in process inventory</td>
</tr>
<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 incurrence 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>

C. Standard Costing

M87#43. Under the two-variance method for analyzing factory overhead, the factory overhead applied to production 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>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>

M88#43. Under the two-variance method for analyzing factory overhead, the difference between the actual factory overhead and the budget allowance based on standard hours allowed is the
a. Net overhead variance.
b. Efficiency variance.
c. Volume variance.
d. Controllable (budget) variance.

M86#43. When using the two-variance method for analyzing factory overhead, the difference between the budget allowance based on standard hours allowed and the factory overhead applied to production is the
a. Net overhead variance.
b. Controllable variance.
c. Volume variance.
d. Efficiency variance.

N85#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>

N85#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.

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
a. Net overhead variance.
b. Controllable variance.
c. Efficiency variance.
d. Spending variance.

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>

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.
Accounting Theory

M84#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.

M84#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>

M83#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.

M83#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>

M83#48. Under the two-variance method for analyzing factory overhead, the controllable (budget) variance is the difference between the
   a. Budget allowance based on standard hours allowed and the factory overhead applied to production.
   b. Budget allowance based on standard hours allowed and the budget allowance based on actual hours worked.
   c. Actual factory overhead and the factory overhead applied to production.
   d. Actual factory overhead and the budget allowance based on standard hours allowed.

D. Joint and By-Product Costing, Spillage, Waste, and Scrap

M87#44. For the purposes of cost accumulation, which of the following are identifiable as different individual products before the split-off point?

<table>
<thead>
<tr>
<th>By-products</th>
<th>Joint products</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>

M86#44. By-products could have which of the following characteristics?

<table>
<thead>
<tr>
<th>Zero costs beyond split-off</th>
<th>Additional costs beyond split-off</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>

M86#44. Which of the following is often subject to further processing in order to be salable?

<table>
<thead>
<tr>
<th>By-products</th>
<th>Scrap</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#50. By-products
   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.

M84#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.
Selected Questions

MB4#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.

E. Absorption and Variable Costing

MB7#45. In an income statement prepared as an internal report using the absorption costing method, which of the following terms should appear?

<table>
<thead>
<tr>
<th>Contribution margin</th>
<th>Gross profit (margin)</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>

N86#45. An allocated portion of fixed factory overhead is included in work in process inventory under

MB4#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.

N83#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.

MB8#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.

N84#53. An allocated portion of fixed factory overhead would

MB5#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.

N86#45. In an income statement prepared as an internal report using the variable costing method, fixed factory overhead would

a. Not be used.
b. Be used in the computation of operating income but not in the computation of the contribution margin.
c. Be used in the computation of the contribution margin.
d. Be treated the same as variable factory overhead.

MB6#45. In an income statement prepared as an internal report using the variable costing method, variable selling and administrative expenses would

a. Not be used.
b. Be 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 fixed selling and administrative expenses.

N84#53. An allocated portion of fixed factory overhead is included in work in process inventory under

MB4#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.

N83#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.

MB8#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.

T-37
F. Budgeting and Flexible Budgeting

M87#46. The flexible budget for a producing department may include

<table>
<thead>
<tr>
<th>Direct labor</th>
<th>Factory overhead</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>

N86#46. When a flexible budget is used, a decrease in production levels within a relevant range would
- a. Decrease variable cost per unit.
- b. Decrease total fixed costs.
- c. Increase total fixed costs.
- d. Increase variable cost per unit.

M86#46. A flexible budget is appropriate for a (an)

<table>
<thead>
<tr>
<th>Administrative budget</th>
<th>Direct material budget</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>

N85#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.

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#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>

G. Breakeven and Cost-Volume-Profit Analysis

M87#47. Breakeven analysis assumes over the relevant range that
- a. Total costs are linear.
- b. Fixed costs are nonlinear.
- c. Variable costs are nonlinear.
- d. Selling prices are nonlinear.

N86#48. The contribution margin ratio always increases when the
- a. Variable costs as a percentage of net sales increase.
- b. Variable costs as a percentage of net sales decrease.
- c. Breakeven point increases.
- d. Breakeven point decreases.

M86#47. In using cost-volume-profit analysis to calculate an expected sales level expressed in units, which of the following should be subtracted from fixed costs in the numerator?
- a. Predicted operating loss.
- b. Predicted operating profit.
- c. Unit contribution margin.
- d. Variable costs.

N85#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.

M85#44. How would the following be used in calculating the expected sales level expressed in units?

<table>
<thead>
<tr>
<th>Contribution margin per unit</th>
<th>Estimated operating loss</th>
</tr>
</thead>
<tbody>
<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.
Selected Questions

**N84#55.** 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>

**M84#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.

**H. Capital Budgeting Techniques**

**M87#48.** 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 future amount of the estimated salvage value.
d. Included as a cash inflow at the present value of the estimated salvage value.

**N86#49.** 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>Net present value</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>

**M86#48.** The net present value capital budgeting technique can be used when cash flows from period to period are

<table>
<thead>
<tr>
<th>Uniform</th>
<th>Uneven</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>

**N85#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.

**N85#48.** The payback capital budgeting technique considers

<table>
<thead>
<tr>
<th>Income over entire life of project</th>
<th>Time value of money</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#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>

**N84#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.

N83#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>

I. Performance Analysis

M87#49. A company's rate of return on investment is the
a. Percentage of profit to sales divided by the capital-employed turnover rate.
 b. Percentage of profit to sales multiplied by the capital-employed turnover rate.
 c. Investment capital divided by the capital-employed turnover rate.
 d. Investment capital multiplied by the capital-employed turnover rate.

N86#47. The invested capital-employed turnover rate would include
a. Sales in the denominator.
 b. Net income in the numerator.
 c. Invested capital in the denominator.
 d. Invested capital in the numerator.

M86#49. Assuming that sales and net income remain the same, a company's return on investment will
a. Increase if invested capital increases.
 b. Decrease if invested capital decreases.
 c. Decrease if the invested capital-employed turnover rate decreases.
 d. Decrease if the invested capital-employed turnover rate increases.

N85#49. A company's return on investment is affected by a change in

<table>
<thead>
<tr>
<th>Capital turnover</th>
<th>Profit margin on sales</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#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.

N84#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.

N83#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

M87#50. How would the following be used in the economic order quantity formula?

<table>
<thead>
<tr>
<th>Inventory carrying cost</th>
<th>Cost per purchase order</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Denominator</td>
<td>Denominator</td>
</tr>
<tr>
<td>c. Denominator</td>
<td>Denominator</td>
</tr>
<tr>
<td>d. Not used</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

N86#50. Simple regression analysis involves the use of

<table>
<thead>
<tr>
<th>Dependent variables</th>
<th>Independent variables</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. One</td>
<td>None</td>
</tr>
<tr>
<td>b. One</td>
<td>One</td>
</tr>
<tr>
<td>c. Two</td>
<td>Two</td>
</tr>
<tr>
<td>d. None</td>
<td>Two</td>
</tr>
</tbody>
</table>

M86#50. In the contribution margin approach to pricing, the price at which the income remains constant is equal to the price that covers
a. Prime costs.
 b. Variable costs.
 c. Fixed costs.
 d. Fixed and variable costs plus the desired profit.

N85#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.
Selected Questions

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 a (an)

M83#50. The economic order quantity formula can be used to determine the optimum size of a

<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>

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework

M87#51. Under the modified accrual basis of accounting for a governmental unit, revenues should be recognized in the accounting period in which they
   a. Are earned and become measurable.
   b. Are collected.
   c. Become available and earned.
   d. Become available and measurable.

N85#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?

<table>
<thead>
<tr>
<th>Accrual basis</th>
<th>Modified accrual basis</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>

B. Fund Accounting

M87#52. The appropriations control account of a governmental unit is credited when
   a. Supplies are purchased.
   b. Expenditures are recorded.
   c. The budget is recorded.
   d. The budgetary accounts are closed.

M87#53. The expenditures control account of a governmental unit is credited when
   a. The budgetary accounts are closed.
   b. The budget is recorded.
   c. Supplies are purchased.
   d. Supplies previously encumbered are received.

N86#52. When the budget of a governmental unit, for which the estimated revenues exceed the appropria-
Accounting Theory

tions, is adopted and recorded in the general ledger at the beginning of the year, the budgetary fund balance account is

- Credited at the beginning of the year and no entry made at the end of the year.
- Credited at the beginning of the year and debited at the end of the year.
- Debited at the beginning of the year and no entry made at the end of the year.
- Debited at the beginning of the year and credited at the end of the year.

N86#53. Which of the following accounts of a governmental unit is debited when supplies previously ordered are received?

- Appropriations control.
- Encumbrances control.
- Fund balance reserved for encumbrances.
- Vouchers payable.

M86#52. Which of the following accounts of a governmental unit is credited when supplies previously ordered are received?

- Fund balance reserved for encumbrances.
- Encumbrances control.
- Expenditures control.
- Appropriations control.

M86#53. The revenues control account of a governmental unit is debited when

- The budget is recorded at the beginning of the year.
- The account is closed out at the end of the year.
- Property taxes are recorded.
- Property taxes are collected.

N85#53. When a truck is received by a governmental unit, the truck should be recorded in the general fund as a debit to (an)

- Appropriations control.
- Encumbrances control.
- Fixed asset.
- Expenditures control.

M85#52. The appropriations control account of a governmental unit is debited when

- The budgetary accounts are closed.
- The budget is recorded.
- Supplies are purchased.
- Expenditures are recorded.

M85#53. Which of the following accounts of a governmental unit is credited when a purchase order is approved?

- Encumbrances control.
- Fund balance reserved for encumbrances.
- Vouchers payable.
- Appropriations control.

M84#51. When the budget of a governmental unit is adopted and the estimated revenues exceed the appropriations, the excess is

- Credited to fund balance.
- Debit to fund balance.
- Credited to reserve for encumbrances.
- Debit to reserve for encumbrances.

M84#52. The estimated revenues account of a governmental unit is credited when

- The budget is closed out at the end of the year.
- The budget is recorded.
- Property taxes are recorded.
- 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

- Credited for the estimated price on the purchase order.
- Credited for the actual price for the supplies received.
- Debit for the estimated price on the purchase order.
- Debit for the actual price for the supplies received.

N83#51. Which of the following accounts of a governmental unit is credited when the budget is recorded?

- Encumbrances.
- Reserve for encumbrances.
- Estimated revenues.
- Appropriations.

N83#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?

- No journal entry should have been made in the general fund.
- Fixed assets.
- Expenditures.
- 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?

- Appropriations are less than expenditures and reserve for encumbrances.
- Appropriations are less than expenditures and encumbrances.
- Appropriations are more than expenditures and encumbrances.
- Appropriations are more than estimated revenues.
Selected Questions

**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.

C. Types of Funds and Fund Accounts

**M87#54.** Which of the following funds of a governmental unit uses the modified accrual basis of accounting?
   a. Enterprise.
   b. Internal service.
   c. Capital projects.
   d. Nonexpendable trust.

**M87#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.

**M87#56.** Which of the following accounts would be included in the fund equity section of the combined balance sheet of a governmental unit for the general fixed asset account group?

<table>
<thead>
<tr>
<th>Investment in general fixed assets</th>
<th>Fund balance reserved for encumbrances</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>

**M87#57.** Funds which the governing board of an institution, rather than a donor or other outside agency, has determined are to be retained and invested for other than loan or plant purposes would be accounted for in the
   a. Quasi-endowment fund.
   b. Endowment fund.
   c. Agency fund.
   d. Current fund-restricted.

**N86#54.** Which of the following funds of a governmental unit integrates budgetary accounts into the accounting system?
   a. Enterprise.
   b. Internal service.
   c. Special revenue.
   d. Nonexpendable trust.

**N86#56.** The total assets of the general long-term debt account group of a governmental unit consist of the
   a. Amount available in debt service funds account plus the amount to be provided for retirement of general long-term debt account.
   b. Amount available in debt service funds account minus the amount to be provided for retirement of general long-term debt account.
   c. Amount available in debt service funds account only.
   d. Amount to be provided for retirement of general long-term debt account only.

**N86#57.** How would customers' security deposits which can not be spent for normal operating purposes be classified in the balance sheet of the enterprise fund of a governmental unit?

<table>
<thead>
<tr>
<th>Restricted asset</th>
<th>Liability</th>
<th>Fund equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**M86#54.** Fixed assets used by a governmental unit should be accounted for in the

<table>
<thead>
<tr>
<th>Capital projects fund</th>
<th>General fund</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>

**M86#55.** Fixed assets of an enterprise fund should be accounted for in the
   a. General fixed asset account group but no depreciation on the fixed assets should be recorded.
   b. General fixed asset account group and depreciation on the fixed assets should be recorded.
   c. Enterprise fund but no depreciation on the fixed assets should be recorded.
   d. Enterprise fund and depreciation on the fixed assets should be recorded.

T-43
**Accounting Theory**

M86#56. Which type of fund can be either expendable or nonexpendable?
   a. Debt service.
   b. Enterprise.
   c. Special revenue.
   d. Trust.

M85#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.

M85#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.

M85#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.

M85#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.

M85#54. The special revenue fund of a governmental unit is an example of what type of fund?
   a. Governmental.
   b. Proprietary.
   c. Internal service.
   d. Fiduciary.

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?
   a. Internal service.
   b. Governmental.
   c. Proprietary.
   d. 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?
   a. Special revenue.
   b. Capital projects.
   c. Internal service.
   d. General.

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#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>
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</table>
Selected Questions

**M83#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#54.** Which of the following funds of a governmental unit uses the modified accrual basis of accounting?

- a. General.
- b. Enterprise.
- c. Internal service.
- d. Nonexpendable trust.

**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#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>

**D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations**

**M87#58.** In the comprehensive annual financial report (CAFR) of a governmental unit, the account groups are included in

- a. Both the combined balance sheet and the combined statement of revenues, expenditures, and changes in fund balances.
- b. The combined statement of revenues, expenditures, and changes in fund balances, but not the combined balance sheet.
- c. The combined balance sheet but not the combined statement of revenues, expenditures, and changes in fund balances.
- d. Neither the combined balance sheet nor the combined statement of revenues, expenditures, and changes in fund balances.

**N86#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>Account groups</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>
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<tr>
<td>d. No</td>
<td>No</td>
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</table>

**M86#58.** The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenses, and changes in retained earnings for

<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>
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</tbody>
</table>

**N85#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>
</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. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**M85#58.** The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined balance sheet for

<table>
<thead>
<tr>
<th>Governmental funds</th>
<th>Proprietary funds</th>
<th>Account groups</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>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**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>
</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>
Accounting Theory

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>
</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>

E. Various Types of Not-for-Profit and Governmental Organizations

M87#59. Which of the following normally would be included in Other Operating Revenues of a hospital?

<table>
<thead>
<tr>
<th>Revenue from educational programs</th>
<th>Unrestricted gifts</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>

M86#60. In a statement of support, revenue, and expenses and changes in fund balances of a voluntary health and welfare organization, depreciation expense should

- a. Not be included.
- b. Be included as an element of support.
- c. Be included as an element of other changes in fund balances.
- d. Be included as an element of expense.

M86#59. The plant funds group of a not-for-profit private university includes which of the following subgroups?

<table>
<thead>
<tr>
<th>Investment in plant funds</th>
<th>Unexpanded plant 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>

M86#60. Revenue from the parking lot operated by a hospital would normally be included in

- a. Patient service revenue.
- b. Ancillary service revenue.
- c. Other operating revenue.
- d. Other nonoperating revenue.

M86#59. The current funds group of a not-for-profit private university includes which of the following?

<table>
<thead>
<tr>
<th>Annuity funds</th>
<th>Loan 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>

M86#60. Securities donated to a voluntary health and welfare organization should be recorded at the

- a. Donor's recorded amount.
- b. Fair market value at the date of the gift.
- c. Fair market value at the date of the gift, or the donor's recorded amount, whichever is lower.
- d. Fair market value at the date of the gift, or the donor's recorded amount, whichever is higher.

M85#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


M85#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.

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>
</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#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>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<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>
### I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

**B. Conceptual Framework**

<table>
<thead>
<tr>
<th>Question</th>
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<td>M84 # 4 a</td>
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<tr>
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<td>M84 # 5 e</td>
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<tr>
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**E. Consolidated Financial Statements**

<table>
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<td>M84 # 13 d</td>
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<tr>
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<td>N83 # 10 c</td>
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**C. Basic Concepts and Accounting Principles**

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

**A. Cash, Marketable Securities, and Investments**

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<td>M84 # 11 d</td>
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<td>M84 # 13 d</td>
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<td>M85 # 19 c</td>
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<tr>
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<td>M86 # 19 c</td>
</tr>
<tr>
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<td>M85 # 12 c</td>
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**D. Property, Plant, and Equipment Owned or Leased**

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<td>N86 # 10 d</td>
<td>N84 # 12 b</td>
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<tr>
<td>M86 # 17 c</td>
<td>N84 # 13 b</td>
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<td>N84 # 14 b</td>
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<td>M84 # 16 d</td>
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**E. Intangibles and Other Assets**

<table>
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<th>Question</th>
<th>Answer</th>
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<td>M85 # 13 d</td>
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**B. Receivables and Accruals**

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<td>N84 # 16 a</td>
<td>M83 # 19 d</td>
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T-49
III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

C. Deferred Income

M87#10 b  M87#15 c  M86#27 d  N84#23 a
M87#11 a  N86#12 d  N85#11 c  N84#24 c
N86#16 d  N86#13 c  N84#22 c  N84#25 a
M86#13 b  M86#22 a  M83#19 a  N83#14 d
M85#14 b  M86#23 c  M83#22 b  N83#15 d
M85#15 a  N85#10 a  M87#16 a  N83#16 d
N84#21 a  M84#20 b  M87#17 d  N83#17 b
M84#16 d  M84#21 c  M87#18 d  N85#17 b
M84#17 d  M83#20 c  N86#18 c  N83#18 b
N83#13 a  D. Capitalized Lease
M83#21 b  M85#19 c

B. Deferred Revenues

M87#13 c  N84#29 a
M87#12 b  N85#13 a
N85#9 b  N85#14 d
M86#26 c  N85#15 b

E. Bonds Payable

M83#24 b  M83#30 a

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

C. Retained Earnings

N86#20 a  M87#20 c  M87#33 d  N84#23 a
M85#19 c  M87#21 d  N86#23 c  N86#31 b
N86#21 c  M85#31 b  N86#12 d

B. Additional Paid-in Capital

M86#22 d  M85#18 a  M85#19 c
M86#14 b  N84#18 a  N84#28 a
M86#15 a  N84#29 d  N85#19 d
M85#17 b  M84#25 b  N85#16 c
N84#27 a  N83#22 b  N84#19 c
N83#19 d  M83#27 c  N83#18 b

G. Partnerships

M87#35 d  M86#32 d  M84#26 a

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#32 c  M85#23 c
N84#32 c  N84#34 d
M87#26 a  M87#22 c  N84#35 d
M87#27 a  M87#23 d  M84#27 b
N86#24 d  M87#24 d  N83#26 a
N86#25 a  M87#25 b  M83#31 c
M86#33 c  N86#27 a  M83#32 c
N85#20 b  M86#34 a  M83#34 a
N85#21 a  N85#16 b  N85#17 d
M85#21 c

T-50
Unofficial Answers

C. Provision for Income Tax
D. Recurring Versus Nonrecurring Transactions and Events
E. Accounting Changes
F. Earnings Per Share

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VI. Other Financial Topics

A. Statement of Changes in Financial Position
C. Accounting Changes
D. Nonmonetary Transactions
E. Business Combinations
B. Accounting Policies

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I. Employee Benefits
F. Interim Financial Statements
J. Analysis of Financial Statements
H. Segments and Lines of Business
K. Development Stage Enterprises
L. Personal Financial Statements

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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

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T-51
E. Absorption and Variable Costing

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F. Budgeting and Flexible Budgeting

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A. Conceptual Framework

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B. Fund Accounting

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C. Types of Funds and Fund Accounts

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D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

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E. Various Types of Not-for-Profit and Governmental Organizations

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VIII. Not-for-Profit and Governmental Accounting
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:

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<th>Bridge Company</th>
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<td><strong>Assets:</strong></td>
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<td>Current assets:</td>
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<tr>
<td>Cash</td>
<td>$103,500</td>
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<td>$800</td>
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<td>Marketable equity securities, at cost which approximates market</td>
<td>13,000</td>
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<tr>
<td>Accounts receivable, net of allowance for doubtful accounts</td>
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<td>24,700</td>
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<td>Inventories, at lower of cost or market</td>
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<td>25,000</td>
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<td>Prepaid expenses</td>
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<td>500</td>
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<td>Total current assets</td>
<td>250,000</td>
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<tr>
<td>Property, plant, and equipment, net of accumulated depreciation</td>
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<tr>
<td>Other assets</td>
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<td>62,000</td>
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<tr>
<td>Total assets</td>
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<td>$119,000</td>
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<td><strong>Liabilities:</strong></td>
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<td>Total liabilities (condensed)</td>
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<td>$65,000</td>
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<td><strong>Stockholders’ equity:</strong></td>
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<td>Common stock, par value $1.00 per share</td>
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<td>Additional paid-in capital</td>
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<td>Retained earnings</td>
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<td>Total stockholders’ equity</td>
<td>263,000</td>
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<td>Total liabilities and stockholders’ equity</td>
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<td>$119,000</td>
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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

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<td>$ 7,200</td>
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<td>26,000</td>
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<td>Accounts receivable, net of allowance for doubtful accounts</td>
<td>210,000</td>
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<td>Inventories</td>
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Pace Company
STATEMENTS OF INCOME

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<th>Year ended December 31, 1982</th>
<th>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>

T-54
Selected Questions

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><strong>Total</strong></td>
<td><strong>$252,000</strong></td>
<td><strong>$308,000</strong></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.

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

**M87**

**Number 2 (Estimated time — 15 to 25 minutes)**

Deskin Company purchased a new machine to be used in its operations. The new machine was delivered by the supplier, installed by Deskin, and placed into operation. It was purchased under a long-term payment plan for which the interest charges approximated the prevailing market rates. The estimated useful life of the new machine is ten years, and its estimated residual (salvage) value is significant. Normal maintenance was performed to keep the new machine in usable condition.

Deskin also added a wing to the manufacturing building that it owns. The addition is an integral part of the building. Furthermore, Deskin made significant leasehold improvements to office space used as corporate headquarters.

**Required:**

a. What costs should Deskin capitalize for the new machine? How should the machine be depreciated? **Do not discuss specific methods of depreciation.**

b. How should Deskin account for the normal maintenance performed on the new machine? Why?

c. How should Deskin account for the wing added to the manufacturing building? Where should the added wing be reported on Deskin’s financial statements?

d. How should Deskin account for the leasehold improvements made to its office space? Where should the leasehold improvements be reported on Deskin’s financial statements?

**M87**

**Number 3 (Estimated time — 15 to 25 minutes)**

Hanlon Company purchased a significant amount of raw materials inventory for a new product that it is manufacturing. Hanlon purchased insurance on these raw materials while they were in transit from the supplier.

Hanlon uses the lower of cost or market rule for these raw materials. The replacement cost of the raw materials is above the net realizable value and both are below the original cost.

Hanlon uses the average cost inventory method for these raw materials. In the last two years, each purchase
has been at a lower price than the previous purchase, and the ending inventory quantity for each period has been higher than the beginning inventory quantity for that period.

Required:

a. What is the theoretically appropriate method that Hanlon should use to account for the insurance costs on the raw materials while they were in transit from the supplier? Why?

b. 1. At which amount should Hanlon's raw materials inventory be reported on the balance sheet? Why?

c. In general, why is the lower of cost or market rule used to report inventory?

d. What would have been the effect on ending inventory and cost of goods sold had Hanlon used the LIFO inventory method instead of the average cost inventory method for the raw materials? Why?

N85 Number 2 (Estimated time — — 15 to 25 minutes)

Anth Company has significant amounts of trade accounts receivable. Anth uses the allowance method to estimate bad debts instead of the specific write-off method. During the year, some specific accounts were written off as uncollectible, and some that were previously written off as uncollectible were collected.

Anth also has some interest-bearing notes receivable for which the face amount plus interest at the prevailing rate of interest is due at maturity. The notes were received on July 1, 1985, and are due on June 30, 1987.

Required:

a. What are the deficiencies of the specific write-off method?

b. What are the two basic allowance methods used to estimate bad debts, and what is the theoretical justification for each?

c. How should Anth account for the collection of the specific accounts previously written off as uncollectible?


N85 Number 2 (Estimated time — — 15 to 25 minutes)

Gehl 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?

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?

d. How does the calculation of dollar value LIFO differ from the conventional quantity of goods method?

e. How should Caddell account for the inventories consigned to Reed Company? Why?

N85 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.
Selected Questions

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?

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 noninterest-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 inventoryable?
   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.

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

**M83 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?

---

**M86 Number 3 (Estimated time — 15 to 25 minutes)**

On January 1, 1985, Hendrick Company entered into two noncancellable leases for machines to be used in its manufacturing operations. The first lease transfers ownership of the machine to the lessee by the end of the lease term. The second lease contains a bargain purchase option. Payments have been made on both leases during 1985.

**Required:**

a. How should Hendrick classify each of the two leases? Why?

b. How should a lessee report a capital lease on its balance sheet and income statement?

c. How should a lessee report an operating lease on its balance sheet and income statement?

---

**M86 Number 4 (Estimated time — 15 to 25 minutes)**

Cope Company is a manufacturer of household appliances. During the year, the following information became available:

- One of its manufacturing plants is located in a foreign country. There is a threat of expropriation of this plant. The threat of expropriation is deemed to be reasonably possible. Any compensation from the foreign government would be less than the carrying amount of the plant.

- It is probable that damages will be received by Cope next year as a result of a lawsuit filed this year against another household appliances manufacturer.

**Required:** In answering the following, do not discuss deferred income tax implications.

a. How should Cope report the probable warranty costs? Why?

b. How should Cope report the threat of expropriation of assets? Why?

c. How should Cope report this year the probable damages that may be received next year? Why?

---

**M86 Number 5 (Estimated time — 15 to 25 minutes)**

On November 1, 1985, Abbott Company sold its 5-year, $1,000 face value, 11% term bonds dated October 1, 1985, at a discount resulting in an effective annual interest rate (yield) of 12%. Interest is payable
Selected Questions

semiannually, and the first interest payment date is April 1, 1986. Abbott uses an acceptable method of amortizing bond discount. Bond issue costs were incurred in preparing and selling the bond issue.

On December 1, 1985, Abbott sold its 6-year, $1,000 face value, 9% nonconvertible bonds with detachable stock warrants for an amount exceeding the sum of the face value of the bonds and the fair value of the warrants.

Required:
a. What facts above determined that the 11% term bonds were sold at a discount? Why?
b. How would all the items related to the 11% term bonds, except cash, be presented in a balance sheet prepared immediately after the term bond issue was sold, and in a balance sheet prepared at December 31, 1985?
c. 1. Over what period of time would the bond discount be amortized?
   2. Compare the straight-line and the interest methods of amortization.
   3. Which of the two methods is preferable? Why?
d. How should Abbott account for the proceeds from the sale of the 9% nonconvertible bonds with detachable stock purchase warrants? Why?

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?
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 insurable flood risk? Why?
   c. How should Angela account for the toy promotion campaign in this year?

M84
Number 3 (Estimated time — 15 to 25 minutes)

On March 1, 1983, Wesley Company sold its 5-year, $1,000 face value, 8% bonds dated March 1, 1983, at an effective annual interest rate (yield) of 10%. Interest is payable semiannually and the first interest payment date is September 1, 1983. Wesley uses the interest method of amortization. Bond issue costs were incurred in preparing and selling the bond issue. The bonds can be called by Wesley at 101 at any time on or after March 1, 1984.

Required:
   a. 1. How would the selling price of the bond be determined?
      2. Specify how all items related to the bonds would be presented in a balance sheet prepared immediately after the bond issue was sold.
   b. What items related to the bond issue would be included in Wesley's 1983 income statement, and how would each be determined?
   c. Would the amount of bond discount amortization using the interest method of amortization be lower in the second or third year of the life of the bond issue? Why?
   d. Assuming that the bonds were called in and retired on March 1, 1984, how should Wesley report the retirement of the bonds on the 1984 income statement?

M83
Number 5 (Estimated time — 15 to 25 minutes)

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.
Selected Questions

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

N85
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?

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>December 31,</th>
<th>1982</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>(000 omitted)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

$22,000 $20,000

Additional paid-in capital

240,000 222,000

Retained earnings

296,000 280,000

$558,000 $522,000

Lynch Company

STATEMENT OF RETAINED EARNINGS

<table>
<thead>
<tr>
<th>Year ended December 31,</th>
<th>1982</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>(000 omitted)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Retained earnings at beginning of period, as previously reported

$280,000 $264,000

Adjustment for extraordinary item

14,000 —

Retained earnings at beginning of period, as restated

294,000 264,000

Net income

52,400 47,400

Adjustment for correction of error

— (11,000)

Cash dividends

(24,400) (20,400)

10% stock dividend

(20,000) —

Treasury stock

(6,000) —

Retained earnings at end of period

$296,000 $280,000
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

**M87**

**Number 4 (Estimated time — 15 to 25 minutes)**

Lynn Company discontinued operations of a segment of its business in the middle of the year. The segment was operating at a loss from the beginning of the year. At the measurement date, a loss is expected from the proposed sale of the segment. This expected loss includes operating losses during the phase-out period which will extend into next year.

In addition, Lynn had one of its manufacturing plants destroyed by an earthquake during the year. The loss is properly reported as an extraordinary item.

**Required:**

a. How should Lynn report discontinued operations of a segment of its business on its income statement for this year? **Do not discuss earnings per share requirements.**

b. What are the criteria for classification as an extraordinary item?

c. How should Lynn report the extraordinary loss from the earthquake on its income statement for this year? **Do not discuss earnings per share requirements.**

**M86**

**Number 5 (Estimated time — 15 to 25 minutes)**

Wesley Company granted compensatory common stock options to its executives on January 1, 1983, the measurement date, for services to be rendered during 1983 and 1984. The quoted market price of Wesley's par value common stock exceeded the option price on January 1, 1983.

The stock options were exercisable beginning on January 1, 1985, and they lapsed on December 31, 1985.

Half of the stock options were exercised in 1985 and half were allowed to lapse.

**Required:**

a. How should Wesley determine the amount of compensation expense related to the compensatory stock options, if any, that should be recognized in its income statements for 1983, 1984, and 1985? Why?

b. How should Wesley account for the exercise of the stock options? Justify the accounting recommended.

c. How should Wesley account for the lapse of the stock options? Justify the accounting recommended.

**M86**

**Number 2 (Estimated time — 15 to 25 minutes)**

Village Company is accounting for a long-term construction contract using the percentage-of-completion method. It is a three-year fixed-fee contract that is presently in its first year. The latest reasonable estimates of total contract costs indicate that the contract will be completed at a profit. Village will submit progress billings to the customer and has reasonable assurance that collections on these billings will be received in each year of the contract.

**Required:**

a. 1. What is the justification for the percentage-of-completion method for long-term construction contracts?

2. What facts in the situation above indicate that Village should account for this long-term construc-
Selected Questions

M86
Number 3 (Estimated time — 15 to 25 minutes)

Berkeley Company, a manufacturer of many different products, changed its depreciation method for its production machinery from the double-declining balance method to the straight-line method effective January 1, 1985. The straight-line method was determined to be preferable.

In addition, Berkeley changed the salvage values used in computing depreciation for its office equipment. This change was made on January 1, 1985, because additional information was obtained.

On December 31, 1985, Berkeley changed the specific subsidiaries comprising the group of companies for which consolidated financial statements are presented.

Required:

a. What kind of accounting change is each of the three situations described above? For each situation indicate whether or not each should show:
   • The cumulative effect of a change in accounting principle in net income of the period of change.
   • Pro forma effects of retroactive application.
   • Restatement of the financial statements of all prior periods.

b. Why does a change in accounting principle have to be disclosed by the company?

c. How would Primrose determine and account for the income tax effect for the depreciation and rent? Why?

d. How should Primrose classify the income tax effect of the depreciation and rent on its balance sheet and income statement? Why?

M85
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.

M83
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.

T-63
VI. Other Financial Topics

M87
Number 5 (Estimated time — — 15 to 25 minutes)

Flaherty Company entered into a business combination with Steeley Company in the middle of the year. The combination was accounted for as a pooling of interests. Both companies use the same methods of accounting. Registration fees for the equity securities involved in the combination were incurred. There were no intercompany transactions before or after the combination.

Flaherty Company acquired all of the voting common stock of Rubin Company in the middle of the year. This combination was accounted for as a purchase and resulted in goodwill. Both companies use the same methods of accounting. Registration fees for the equity securities involved in the combination were incurred. There were no intercompany transactions before or after the combination.

Required:

a. 1. In the business combination accounted for as a pooling of interests, how should the recorded assets and liabilities of the separate companies be accounted for? What is the rationale for accounting for a business combination as a pooling of interests?

2. In the business combination accounted for as a pooling of interests, how should the registration fees and direct costs related to effecting the business combination be accounted for?

3. In the business combination accounted for as a pooling of interests, how should the results of operations for the year in which the business combination occurred be reported?

b. 1. In the business combination accounted for as a purchase, how should the assets acquired and liabilities assumed be recorded? What is the rationale for accounting for a business combination as a purchase?

2. In the business combination accounted for as a purchase, how should the registration fees and direct costs related to effecting the business combination be accounted for?

3. In the business combination accounted for as a purchase, how should the results of operations for the year in which the business combination occurred be reported?

M86
Number 4 (Estimated time — — 15 to 25 minutes)

Spellman Company will acquire 90% of Moore Company in a business combination. The total consideration has been agreed upon. The nature of Spellman’s payment has not been fully agreed upon. Therefore, it is possible that this business combination might be accounted for as either a purchase or a pooling of interests. It is expected that at the date the business combination is to be consummated, the fair value will exceed the book value of Moore’s assets minus liabilities. Spellman desires to prepare consolidated financial statements which will include the financial statements of Moore.

Required:

a. 1. Would the method of accounting for the business combination (purchase vs. pooling of interests) affect whether or not goodwill is reported?

2. If goodwill is reported, explain how the amount of goodwill is determined.

3. Would the method of accounting for the business combination (purchase vs. pooling of interests) affect whether or not minority interest is reported? If the amount reported differs, explain why.

b. 1. From a theoretical standpoint, why should consolidated financial statements be prepared?

2. From a theoretical standpoint, what is the usual first necessary condition to be met before consolidated financial statements can be prepared?

3. From a theoretical standpoint, does the method of accounting for the business combination (purchase vs. pooling of interests) affect the decision to prepare consolidated financial statements? Why?

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.
Selected Questions

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.

VIII. Not-for-Profit and Governmental Accounting

NB4
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?
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.

M83 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 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.”

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

M87
Answer 2 (10 points)

a. The capitalizable cost includes all costs relating to purchase or preparation for use. Such cost may include delivery and installation. The capitalizable cost represents the cash equivalent price and accordingly would not include interest charges. The depreciable cost of the new machine should be allocated over its estimated useful life in a systematic and rational manner. Depreciable cost is the capitalizable cost less its estimated residual (salvage) value.

b. Normal maintenance performed on the new machine should not be capitalized as part of the machine’s cost. It should be expensed as incurred if the machine is not used in the manufacturing process or should be inventoried as part of factory overhead if the machine is used in the manufacturing process. Normal maintenance does not enhance the service potential of the machine.

c. The wing added to the manufacturing building should be capitalized. The addition should be depreciated over its estimated useful life or the remaining useful life of the building of which it is an integral part, whichever is shorter. The addition should be included in the property, plant, and equipment section of the balance sheet.

d. The leasehold improvements made to the office space should be capitalized. The leasehold improvements should be depreciated (amortized) over their estimated useful lives or the term of the lease, whichever is shorter. The unamortized portion of the leasehold improvements could be included as a separate caption in the property, plant, and equipment section or the amortized assets section of the balance sheet. The amortized portion of the leasehold improvements would be shown as an expense in the income statement.

M87
Answer 3 (10 points)

a. The insurance costs on the raw materials while they were in transit from the supplier should be accounted for as part of inventory. Theoretically, insurance cost on raw materials in transit is a cost associated with readying the goods for sale.

b. 1. Hanlon’s inventory should be reported at net realizable value. According to the lower of cost or market rule, market is defined as replacement cost. However, market cannot exceed net realizable value. In this instance, net realizable value is below original cost.

2. The lower of cost or market rule is used to report the inventory in the balance sheet at its future utility value. It also recognizes a decline in the utility of inventory in the income statement in the period in which the decline occurs.

c. Generally, ending inventory would have been higher and cost of goods sold would have been lower had Hanlon used the LIFO inventory method. Inventory quantities increased and LIFO associates the oldest purchase prices with inventory. However, in this instance, there would have been no effect on ending inventory or cost of goods sold had Hanlon used the LIFO inventory method, because Hanlon’s ending inventory would have been reported at net realizable value according to the lower of cost or market rule. Net realizable value of the inventory is less than either its average cost or LIFO cost.
Unofficial Answers

N86

Answer 2 (10 points)

a. The specific write-off method overstates the trade accounts receivable on the balance sheet by reporting them at more than their net realizable value. Furthermore, because the writeoff often occurs in a period after the revenues were generated, the specific write-off method does not match bad debts expense with the revenues generated by sales in the same period.

b. One allowance method estimates bad debts based on credit sales. The method focuses on the income statement and attempts to match bad debts with the revenues generated by the sales in the same period.

The other allowance method estimates bad debts based on the balance in the trade accounts receivable accounts. The method focuses on the balance sheet and attempts to value the accounts receivable at their future collectible amounts.

c. Anth should account for the collection of the specific accounts previously written off as uncollectible as follows:

- Correction of allowance account by debiting accounts receivable and crediting allowance for doubtful accounts.
- Collection of specific accounts previously written off as uncollectible by debiting cash and crediting accounts receivable.

d. Anth should report the face amount of the interest-bearing notes receivable and the related interest receivable for the period July 1, 1985, through December 31, 1986, on its December 31, 1986, balance sheet as current assets. Both assets are due on June 30, 1987, which is within one year of the date of the balance sheet.

Anth should report interest income from the notes receivable on its income statement for the year ended December 31, 1986. The interest income would be equal to the amount accrued on the notes receivable at the stated rate for twelve months. Interest accrues with the passage of time, and it should be accounted for as an element of income over the life of the notes receivable.

N85

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.

c. 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.

**N85**

**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.

**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 cul-
mination 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 interest 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.

M84
Answer 2 (10 points)

a. 1. Diane's inventorable cost should include all costs incurred to get the lighting fixtures ready for sale to the customer. It includes not only the purchase price of the fixtures but also the other associated costs incurred on the fixtures up to the time they are ready for sale to the customer, for example, transportation in.

2. No, administration costs are assumed to expire with the passage of time and not to attach to the product. Furthermore, administrative costs do not relate directly to inventories, but are incurred for the benefit of all functions of the business.

b. 1. The lower of cost or market rule is used for valuing inventories because of the concept of balance sheet conservatism and because the decline in the utility of the inventories below its cost should be recognized as a loss in the current period.

2. The net realizable value less a normal profit margin should be used to value the inventories because market should not be less than net realizable value less a normal profit margin. To carry the inventories at net realizable value less a normal profit margin provides a means of measuring residual usefulness of an inventory expenditure.

c. Diane's beginning inventories at cost and at retail would be included in the calculation of the cost ratio. Net markdowns would be excluded from the calculation of the cost ratio. This procedure reduces the cost ratio because there is a larger denominator for the cost ratio calculation. Thus the concept of balance sheet conservatism is being followed.

M83
Answer 2 (10 points)

a. Expenditures should be capitalized when they benefit future periods. The cost to acquire the land should be capitalized and classified as land, a nondepreciable asset. Since tearing down the small factory is readying the land for its intended use, its cost is part of the cost of the land and should be capitalized and classified as land. As a result, this cost will not be depreciated as it would if it were classified with the capitalizable cost of the building.

Since rock blasting and removal is required for the specific purpose of erecting the building, its cost is part of the cost of the building and should be capitalized and classified with the capitalizable cost of the building. This cost should be depreciated over the estimated useful life of the building.

The road is a land improvement, and its cost should be capitalized and classified separately as a land improvement. This cost should be depreciated over its estimated useful life.

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)

1. 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 which has been reduced by the cash discounts). 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.

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

N86
Answer 3 (10 points)

a. Hendrick should classify each lease as a capital lease. A capital lease transfers substantially all of the benefits and risks inherent to the ownership of property. In order for a lease to qualify as a capital lease for a lessee, it must meet at its inception one or more of the four criteria established by the Financial Accounting Standards Board.

The first lease is a capital lease because it transfers ownership of the machine to the lessee, Hendrick, by the end of the lease term.

The second lease is also a capital lease because it contains a bargain purchase option.

b. A lessee should report a capital lease on its balance sheet as a noncurrent asset and related liability under lease obligations. The noncurrent asset should be reported at its capitalized cost less accumulated amortization. The liability would be reported at an amount equal to the capitalized cost of the asset reduced by the principal portion of minimum lease payments made by the lessee. In addition, the liability would be appropriately classified as current and long-term debt.

A lessee should report on its income statement amortization which has been determined in a manner consistent with the lessee's normal depreciation policy for owned assets. A lessee should also report as an expense on its income statement the interest portion of the minimum lease payment.

The minimum lease payment should be allocated between a reduction of the liability on the balance sheet and interest expense on the income statement, in a manner which produces a constant periodic rate of interest on the remaining balance of the liability.
c. Normally, operating lease payments should be charged to expense on the income statement over the lease term on a straight-line basis. Therefore, a leased asset and its related obligation should not be reported on the lessee's balance sheet.

**N86**

**Answer 4 (10 points)**

a. Cope should report the probable warranty costs as an expense in the income statement and a liability in the balance sheet because both of the following required conditions for accrual were met:

- It is considered probable that liabilities have been incurred.
- The amount of loss can be reasonably estimated.

In addition, it may be necessary for Cope to disclose the nature of the probable warranty costs in the notes to the financial statements.

b. Cope should disclose the nature of the threat of expropriation of assets in the notes to the financial statements. In addition, an estimate of the possible loss or range of loss should be disclosed in the notes to the financial statements.

Cope should not report the threat of expropriation of assets as an expense in the income statement nor as a liability in the balance sheet because it does not meet both required conditions for accrual. The actual expropriation of assets is only reasonably possible instead of probable.

c. Adequate disclosure should be made of contingencies that result in gains, but care should be exercised to avoid misleading implications as to the likelihood of realization.

Cope should not report this year the probable damages that may be received next year as a gain in the income statement nor as an asset in the balance sheet. Gain contingencies usually are not recorded in the accounts until the gains are realized.

**M86**

**Answer 5 (10 points)**

a. The 11% term bonds were sold at a discount (less than face value) because the effective annual interest rate (yield) of 12% was higher than the stated interest rate of 11%. The bonds provide for the payment of interest of 11%; however, this rate was less than the prevailing or market rate for bonds of similar quality at the time the issue was sold. Therefore, the market value of the bonds at the date of sale must be less than face value so that investors may receive the effective annual interest rate (yield) on their investments.

b. In a balance sheet prepared immediately after the term bond issue was sold, a noncurrent liability, term bonds payable, would be presented at an amount equal to the face value of the bonds less the discount. At December 31, 1985, a noncurrent liability, term bonds payable, would be presented in the balance sheet at the face value of the bonds, less the unamortized discount. Therefore, the amortization of bond discount for November and December 1985 would increase the amount of term bonds payable, net of discount.

The bond issue costs incurred in preparing and selling the bond issue could be presented in one of three ways in a balance sheet prepared immediately after the term bond issue was sold:

- Noncurrent asset, deferred charge
- Reduction of the noncurrent liability, term bonds payable
- Not presented in balance sheet (expensed as incurred in 1985).

At December 31, 1985, the bond issue costs could be presented in one of three ways:

- If the bond issue costs were presented in the balance sheet as a noncurrent asset, deferred charge, the amortization of bond issue costs for November and December 1985 would decrease the amount of the deferred charge.
- If the bond issue costs were presented in the balance sheet as a reduction of the noncurrent liability, term bonds payable, the amortization of bond issue costs for November and December 1985 would increase the amount of the term bonds payable, net of discount.
- If the bond issue costs were expensed as incurred in 1985, there would be no effect from the date the term bond issue was sold to December 31, 1985.

A current liability, accrued interest payable, would be presented in a balance sheet prepared immediately after the term bond issue was sold for accrued interest received for October 1985. At December 31, 1985, the accrued interest payable would include accrued interest received for October 1985 and accrued interest for November and December 1985.

c. 1. Bond discount for bonds sold between interest dates should be amortized over the period the bonds will be outstanding, that is, the period from the date of sale (November 1, 1985) to the maturity date (October 1, 1990).

2. The straight-line method of amortization provides an even dollar amount of amortization each year allocated over the period the bonds are outstanding. The interest method of amortization provides for an increasing dollar amount of amortization each year.

3. The interest method of amortization is preferable to the straight-line method because it provides a constant interest rate when applied to the increasing carrying value.

d. The proceeds from the sale of the 9% nonconvertible bonds with detachable stock purchase warrants
should be accounted for as paid-in capital and long-term debt. Because the detachable stock purchase warrants are equity instruments which have a separate fair value at the issue date, the portion of the proceeds allocable to the warrants should be accounted for as paid-in capital. Because the bonds are debt instruments, the remainder of the proceeds, including the premium, should be accounted for as long-term debt.

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 non-current 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 non-current categories and should be separately identified by Lani in its balance sheet.

M84

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.

N83
Answer 5 (10 points)

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.

N84
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 sale (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.

- 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.

- 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.
Accounting Theory

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.

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.

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

N85

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.
M83
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 is 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

M87
Answer 4 (10 points)

a. Lynn should report the results of discontinued operations separately from continuing operations. Discontinued operations should be shown on Lynn’s income statement immediately below the continuing operations section.

Discontinued operations reported in the income statement should be composed of two separate categories, with each category shown net of income taxes.

- Loss from operations of the discontinued segment from the beginning of the year to the measurement date.
- Loss on disposal of the discontinued segment, including the provision for operating losses during the phase-out period.

b. Both of the following criteria should be met for classification as an extraordinary item. An extraordinary item should be unusual in nature and infrequent in occurrence, taking into account the environment in which the entity operates.

c. First, the extraordinary loss should be shown as a separate item in the income statement below discontinued operations and above cumulative effect of accounting changes. Second, the extraordinary loss should be shown net of applicable income taxes.

N86
Answer 5 (10 points)

a. Wesley’s compensation expense for 1983 should be one half of the excess of the quoted market price over the option price on January 1, 1983, for those shares on which stock options were granted.

Wesley’s compensation expense for 1984 should be
one half of the excess of the quoted market price over the option price on January 1, 1983, for those shares on which stock options were granted.

Wesley should not report compensation expense related to the compensatory stock options for 1985. Compensation expense should be recognized in the income statement of each period in which services are rendered. This procedure relates the compensation expense with the revenues in conformity with the matching principle.

b. Wesley should account for the exercise of the stock options as follows:

- Debit contributed capital-stock options for one half of the amount originally credited to that account on January 1, 1983.
- Debit cash for the proceeds received, which represents the number of shares exercised multiplied by the option price on January 1, 1983.
- Credit common stock for the par value of the stock, and credit contributed capital in excess of par-common for the difference. The objective of this accounting is to assign the appropriate value to contributed capital for common stock issued. That value is the sum of the cash proceeds and the amount that had been assigned originally to contributed capital-stock options for those shares issued.

c. Wesley should account for the lapse of the stock options as follows:

- Debit contributed capital-stock options for one half of the amount originally credited to that account on January 1, 1983.
- Credit contributed capital-expired stock options for the same amount.

This entry reclassifies the expired stock options to contributed capital-expired stock options. Compensation expense is not altered by the fact that some stock options were allowed to lapse.

M86 Answer 2 (10 points)

a. 1. The percentage-of-completion method is justified because revenue is earned as work is performed under the long-term construction contract. As a result, it provides more relevant information. Revenues represent actual or expected cash inflows (or the equivalent) that have occurred or will eventuate as a result of the enterprise’s ongoing major or central operations during the period.

2. Village Company should account for this long-term construction contract using the percentage-of-completion method because this method is preferable when estimates of costs to complete and extent of progress toward completion are reasonably dependable. The facts in the situation also indicate that the right to revenue is established and collectibility assured.

b. The income recognized in each year of this long-term construction contract would be determined using the cost-to-cost method of determining percentage of completion as follows:

- The contract price is the first part of the determination of the total estimated income for each year. The total actual costs (the second part of the determination of the total estimated income for each year) represent all costs incurred from the inception of the project to the end of the current year.
- The estimated total costs (the third part of the determination of the total estimated income for each year) are subtracted from the contract price to arrive at the estimated total income. The estimated total costs consist of the actual costs to date and the estimated costs to complete the contract and would generally change each year.
- The income recognized in the first year would be the percentage of the actual costs to date to the estimated total costs multiplied by the estimated total income. The income recognized in the second (third) year would be the percentage of the actual costs to date to the estimated total costs multiplied by the estimated total income less the income already recognized in the first (first and second) year.

c. Progress billings sent and collections on these billings would not affect the income recognized in each year of this long-term contract.

M86 Answer 3 (10 points)

a. Berkeley’s change in depreciation method is a change in accounting principle. This change in accounting principle should show the cumulative effect of a change in accounting principle in net income of the period of change, and the pro forma effects of retroactive application. This change in accounting principle should not be reported by restating the financial statements of prior periods.

Berkeley’s change in salvage values is a change in accounting principle. This change in accounting estimate should not show the cumulative effect of a change in accounting principle in net income of the period of change, nor should Berkeley show the pro forma effects of retroactive application. Furthermore, this change in accounting estimate should not be reported by restating the financial statements of prior periods.

Berkeley’s change in the specific subsidiaries comprising the group of companies for which consolidated financial statements are presented is a change in reporting entity. This change in reporting entity should not show the cumulative effect of a change in account-
Unofficial Answers

b. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data. There is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. The presumption that a company should not change an accounting principle may be overcome only if the company justifies the use of an alternative acceptable accounting principle on the basis that it is preferable.

M85
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 expense 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.

N84
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 ongoing operations.

N83
Answer 3 (10 points)

a. Michael Company should perform 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.

VI. Other Financial Topics

M87
Answer 5 (10 points)

a. 1. In a pooling of interests, the recorded amounts of the assets and liabilities of the separate companies generally become the recorded amounts of the assets and liabilities of the combined corporation. The existing basis of accounting continues. A pooling of interests transaction is regarded as an arrangement among stockholder groups.

2. In a pooling of interests, the registration fees and direct costs related to effecting the business combination should be deducted in determining the net income of the resulting combined corporation for the period in which the expenses are incurred.

3. In a pooling of interests, the results of operations for the year in which the business combination occurred should be reported as though the companies had been combined as of the beginning of the year.

b. 1. In a purchase, the acquiring corporation should allocate the cost of the acquired company to the assets acquired and liabilities assumed. All identifiable assets acquired and liabilities assumed in the business combination should be recorded at their fair values at date of acquisition. The excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill. A purchase transaction is regarded as a bargained transaction (i.e., a significant economic event which results from bargaining between independent parties) which establishes a new basis of accounting.

2. In a purchase, the registration fees related to effecting the business combination are a reduction of the otherwise determinable fair value of the securities, (usually as a reduction of paid in capital). The direct costs related to effecting the business combination are included as part of the acquisition cost of the acquired company.

3. In a purchase, the results of operations for the year in which the business combination occurred should include income of the acquired company after the date of acquisition by including the revenues and expenses of the acquired company based on the cost to the acquiring corporation.

M86
Answer 4 (10 points)

a. 1. Goodwill does not arise and, therefore, should not be reported if the business combination is accounted for as a pooling of interests. The recorded assets and liabilities of the separate companies generally become the recorded assets and liabilities of the combined corporation.

However, goodwill should be reported if the business combination is accounted for as a purchase.

2. All identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of Moore, should be assigned a portion of the cost of Moore, normally equal to their fair values at date of acquisition. Then, the excess of the cost of Moore over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill.

3. Minority interest should be reported whether the business combination is accounted for as a purchase or a pooling of interests. The amount of minority in-
Unofficial Answers

b. 1. Consolidated financial statements should be prepared in order to present financial position and operating results in a manner more meaningful than in separate statements.

2. The usual first necessary 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 fifty percent of the outstanding voting shares of another company is a condition necessary for consolidation.

3. Consolidated financial statements should be prepared whether a business combination is accounted for as a purchase or a pooling of interests. Control exists and is independent of the method of accounting used.

VII. Cost Accumulation, Planning, and Control

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.
Accounting Theory

VIII. Not-for-Profit and Governmental Accounting

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.

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Auditing

Selected Questions
And Unofficial Answers
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Content Specification Outlines

* No essays were indexed for this group.
† Questions in this area are not classified according to group.

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MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Professional Responsibilities

A. General Standards and Rules of Conduct

M87#1. When performing an audit of a city that is subject to the requirements of the Uniform Single Audit Act of 1984, an auditor should adhere to
a. Governmental Accounting Standards Board General Standards.
b. Governmental Finance Officers Association Governmental Accounting, Auditing, and Financial Reporting Principles.
c. General Accounting Office Standards for Audit of Governmental Organizations, Programs, Activities, and Functions.
d. Securities and Exchange Commission Regulation S-X.

c. Description of the CPA's procedures for responding to an inquiry from a trial board.
d. List of specific crimes that would be considered as acts discreditable to the profession.

N86#5. A violation of the profession's ethical standards would most likely have occurred when a CPA
a. Made arrangements with a bank to collect notes issued by a client in payment of fees due.
b. Joined an accounting firm made up of three non-CPA practitioners.
c. Issued an unqualified opinion on the 1985 financial statements when fees for the 1984 audit were unpaid.
d. Purchased a bookkeeping firm's practice of monthly write-ups for a percentage of fees received over a three-year period.

N86#6. A violation of the profession's ethical standards would least likely have occurred when a CPA in public practice
a. Used a records-retention agency to store the CPA's working papers and client records.
b. Served as an expert witness in a damage suit and received compensation based on the amount awarded to the plaintiff.
c. Referred life insurance assignments to the CPA's spouse, who is a life insurance agent.
d. Served simultaneously as state director of revenues and practiced public accounting in the same state.

N86#12. Which of the following is not required by the generally accepted auditing standard that states that due professional care is to be exercised in the performance of the examination?
 a. Observance of the standards of field work and reporting.
b. Critical review of the audit work performed at every level of supervision.
c. Degree of skill commonly possessed by others in the profession.
d. Responsibility for losses because of errors of judgment.

M87#29. Without the consent of the client, a CPA should not disclose confidential client information contained in working papers to a
a. Voluntary quality control review board.
b. CPA firm that has purchased the CPA's accounting practice.
c. Federal court that has issued a valid subpoena.
d. Disciplinary body created under state statute.

N86#4. The AICPA Code of Professional Ethics contains both general ethical principles that are aspirational in character and also a
a. List of violations that would cause the automatic suspension of the CPA's license.
b. Set of specific, mandatory rules describing minimum levels of conduct the CPA must maintain.

N86#1. As guidance for measuring the quality of the performance of an auditor, the auditor should refer to
b. Generally accepted auditing standards.
c. Interpretations of the Statements on Auditing Standards.
d. Statements on Quality Control Standards.
Auditing

M86#33. The concept of materiality would be least important to an auditor when considering the
a. Decision whether to use positive or negative confirmations of accounts receivable.
b. Adequacy of disclosure of a client’s illegal act.
c. Discovery of weaknesses in a client’s internal accounting control.
d. Effects of a direct financial interest in the client upon the CPA’s independence.

c. Rules acknowledged by the accounting profession because of their universal compliance.
d. Measures of the quality of the auditor’s performance.

M86#18. After beginning an audit of a new client, Larkin, CPA, discovers that the professional competence necessary for the engagement is lacking. Larkin informs management of the situation and recommends another CPA, and management engages the other CPA. Under these circumstances
a. Larkin’s lack of competence should be construed to be a violation of generally accepted auditing standards.
b. Larkin may request compensation from the client for any professional services rendered to it in connection with the audit.
c. Larkin’s request for a commission from the other CPA is permitted because a more competent audit can now be performed.
d. Larkin may be indebted to the other CPA since the other CPA can collect from the client only the amount the client originally agreed to pay Larkin.

M86#19. A violation of the profession’s ethical standards would most likely occur when a CPA who
a. Is also admitted to the Bar represents on letterhead to be both an attorney and a CPA.
b. Writes a newsletter on financial management also permits a publishing company to solicit subscriptions by direct mail.
c. Is controller of a bank permits the bank to use the controller’s CPA title in the listing of officers in its publications.
d. Is the sole shareholder in a professional accounting corporation uses the designation “and company” in the firm title.

M86#22. The profession’s ethical standards would most likely 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. CPA would not be independent.
b. Fee was a competitive bid.
c. Actual fee would be substantially higher.
d. Actual fee would be substantially lower than the fees charged by other CPAs for comparable services.

M86#17. Which of the following best describes what is meant by generally accepted auditing standards?
a. Pronouncements issued by the Auditing Standards Board.
b. Procedures to be used to gather evidence to support financial statements.
c. Rules acknowledged by the accounting profession because of their universal compliance.
d. Measures of the quality of the auditor’s performance.

M86#16. A CPA purchased stock in a client corporation and placed it in a trust as an educational fund for the CPA’s minor child. The trust securities were not material to the CPA but were material to the child’s personal net worth. Would the independence of the CPA be considered to be impaired with respect to the client?
a. Yes, because the stock would be considered a direct financial interest and, consequently, materiality is not a factor.
b. Yes, because the stock would be considered an indirect financial interest that is material to the CPA’s child.
c. No, because the CPA would not be considered to have a direct financial interest in the client.
d. No, because the CPA would not be considered to have a material indirect financial interest in the client.

M86#17. Which of the following best describes what is meant by generally accepted auditing standards?
a. Pronouncements issued by the Auditing Standards Board.
b. Procedures to be used to gather evidence to support financial statements.
c. Rules acknowledged by the accounting profession because of their universal compliance.
d. Measures of the quality of the auditor’s performance.
Selected Questions

N85#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.

N85#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.

N85#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.

N85#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.

N85#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.

N85 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.

On July 18, 1984, William Cream hired the CPA firm of Part & Co. to audit Hickory’s financial statements for the year ended December 31, 1984. Part & Co. performed the audit field work from December 15, 1984, through March 10, 1985.

Part & Co. has offices in Cleveland, the office that performed the Hickory audit, and Chicago.

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.

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.
Auditing

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 accounting 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.

M83#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.
Selected Questions

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.

N86#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#36. 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#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.

B. Control of the Audit

N86#7. Which of the following factors most likely affects the auditor’s judgment about the quantity, type, and content of working papers?

a. The degree of reliance on internal accounting control.
b. The content of the client’s representation letter.
c. The timing of substantive tests completed prior to the balance sheet date.
d. The usefulness of the working papers as a reference source for the client.

N86#8. A written understanding between the auditor and the client concerning the auditor’s responsibility for the discovery of illegal acts is usually set forth in an

a. Client representation letter.
b. Letter of audit inquiry.
c. Management letter.
d. Engagement letter.

N86#9. When one auditor succeeds another, the successor auditor should request the

a. Client to instruct its attorney to send a letter of audit inquiry concerning the status of the prior year’s litigation, claims, and assessments.
b. Predecessor auditor to submit a list of internal accounting control weaknesses that have not been corrected.
c. Client to authorize the predecessor auditor to allow a review of the predecessor auditor’s working papers.
d. Predecessor auditor to update the prior year’s report to the date of the change of auditors.

N86#10. Prior to beginning the field work on a new audit engagement in which a CPA does not possess expertise in the industry in which the client operates, the CPA should

a. Reduce audit risk by lowering the preliminary levels of materiality.
b. Design special substantive tests to compensate for the lack of industry expertise.
c. Engage financial experts familiar with the nature of the industry.
d. Obtain a knowledge of matters that relate to the nature of the entity’s business.

N86#11. A basic objective of a CPA firm is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through

a. A system of peer review.
b. Continuing professional education.
c. A system of quality control.
d. Compliance with generally accepted reporting standards.

N86#4. In connection with the element of professional development, a CPA firm’s system of quality control should ordinarily provide that all personnel

a. Have the knowledge required to enable them to fulfill responsibilities assigned.
b. Possess judgment, motivation, and adequate experience.
c. Seek assistance from persons having appropriate levels of knowledge, judgment, and authority.
d. Demonstrate compliance with peer review directives.
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.

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 not 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.

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.

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.

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.

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.
Selected Questions

M84#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 reprimands 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.

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.

C. Other Responsibilities

M87#4. Which of the following statements best describes the auditor’s responsibility regarding the detection of material errors and irregularities?
   a. The auditor is responsible for the failure to detect material errors and irregularities only when such failure results from the nonapplication of generally accepted accounting principles.
   b. Extended auditing procedures are required to detect material errors and irregularities if the auditor’s examination indicates that they may exist.
   c. The auditor is responsible for the failure to detect material errors and irregularities only when the auditor fails to confirm receivables or observe inventories.
   d. Extended auditing procedures are required to detect unrecorded transactions even if there is no evidence that material errors and irregularities may exist.
Auditing

M87#5. When unable to obtain sufficient competent evidential matter to determine whether certain client acts are illegal, the auditor would most likely issue
a. An unqualified opinion with a separate explanatory paragraph.
b. Either a qualified opinion or an adverse opinion.
c. Either a disclaimer of opinion or a qualified opinion.
d. Either an adverse opinion or a disclaimer of opinion.

M87#6. The primary purpose of a management advisory services engagement is to help the client
a. Become more profitable by relying upon the CPA's existing personal knowledge about the client's business.
b. Improve the use of its capabilities and resources to achieve its objectives.
c. Document and quantify its future plans without impairing the CPA's objectivity or allowing the CPA to assume the role of management.
d. Obtain benefits that are guaranteed implicitly by the CPA.

M86#3. Under Statements on Auditing Standards, which of the following would be classified as an error?
   a. Misappropriation of assets for the benefit of management.
b. Misinterpretation by management of facts that existed when the financial statements were prepared.
c. Preparation of records by employees to cover a fraudulent scheme.
d. Intentional omission of the recording of a transaction to benefit a third party.

M86#10. When the auditor is unable to determine the amounts associated with the illegal acts of client personnel because of an inability to obtain adequate evidence, the auditor should issue a(an)
   a. "Subject to" qualified opinion.
b. Disclaimer of opinion.
c. Adverse opinion.
d. Unqualified opinion with a separate explanatory paragraph.

M86#27. Which of the following control procedures may prevent the failure to bill customers for some shipments?
   a. Each shipment should be supported by a pre-numbered sales invoice that is accounted for.
b. Each sales order should be approved by authorized personnel.
c. Sales journal entries should be reconciled to daily sales summaries.
d. Each sales invoice should be supported by a shipping document.

M86#28. The form of communication with a client in a management advisory service consultation should be
   a. Either oral or written.
b. Oral with appropriate documentation in the work papers.
c. Written and copies should be sent to both management and the board of directors.
d. Written and a copy should be sent to management alone.

15. Since management took no action, Smith should
b. Issue an "except for" qualified opinion or an adverse opinion.
c. Disregard the political contributions since the board of directors were notified and the amounts involved were immaterial.
d. Consider withdrawing from the engagement or dissociating from any future relationship with BCD Corp.

M86#16. When an accountant is not independent of a client and is requested to perform a compilation of its financial statements, the accountant
   a. Is precluded from accepting the engagement.
b. May accept the engagement and need not disclose the lack of independence.
c. May accept the engagement and should disclose the lack of independence, but not the reason for the lack of independence.
d. May accept the engagement and should disclose both the lack of independence and the reason for the lack of independence.

N86 Items 14 and 15 are based on the following information:

During the annual audit of BCD Corp., a publicly held company, Smith, CPA, a continuing auditor, determined that illegal political contributions had been made during each of the past seven years, including the year under audit. Smith notified the board of directors of BCD Corp. of the illegal contributions, but they refused to take any action because the amounts involved were immaterial to the financial statements.

14. Smith should reconsider the intended degree of reliance to be placed on the
b. Preliminary judgment about materiality levels.
c. Letter of audit inquiry to the client's attorney.
d. Prior years' audit programs.
Selected Questions

M86#36. Which of the following statements best describes the auditor’s responsibility regarding the detection of material irregularities?
   a. Because of the inherent limitations of an audit, the auditor is not responsible for the failure to detect material irregularities.
   b. The auditor is responsible for the failure to detect material irregularities when such failure results from nonperformance of audit procedures specifically described in the engagement letter.
   c. The auditor should extend auditing procedures to actively search for evidence of material irregularities where the examination indicates that material irregularities may exist.
   d. The auditor is responsible for the failure to detect material irregularities when the auditor’s evaluation of internal accounting control indicates that there is no basis for any reliance thereon.

M86#37. After an auditor had been engaged to perform the first audit for a nonpublic entity, the client requested to change the engagement to a review. In which of the following situations would there be a reasonable basis to comply with the client’s request?
   a. The client’s bank required an audit before committing to a loan, but the client subsequently acquired alternative financing.
   b. The auditor was prohibited by the client from corresponding with the client’s legal counsel.
   c. Management refused to sign the client representation letter.
   d. The auditing procedures were substantially complete and the auditor determined that an unqualified opinion was warranted, but there was a disagreement concerning the audit fee.

M85#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.

M85#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.

M85#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 as estimates 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.

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.

A-9
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#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#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 advice 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#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 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#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.
Selected Questions

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 not 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.

II. Internal Control

A. Definitions and Basic Concepts

M87#2. When considering internal control, an auditor should be aware of the concept of reasonable assurance, which recognizes that the
a. Segregation of incompatible functions is necessary to ascertain that internal control is effective.
b. Employment of competent personnel provides assurance that the objectives of internal control will be achieved.
c. Establishment and maintenance of a system of internal control is an important responsibility of the management and not of the auditor.
d. Cost of internal control should not exceed the benefits expected to be derived from internal control.

M86#13. A secondary objective of the auditor's study and evaluation of internal accounting control is that the study and evaluation provide
a. A basis for determining the nature, extent, and timing of audit tests.
b. Assurance that management's procedures to detect irregularities are properly functioning.
c. A basis for constructive suggestions concerning improvements in internal accounting control.
d. Evidence that incompatible functions for accounting control purposes have been eliminated.

M86#18. Which of the following is a provision of the Foreign Corrupt Practices Act?
a. It is a criminal offense for an auditor to fail to detect and report a bribe paid by an American business entity to a foreign official for the purpose of obtaining business.

M86#12. Where computer processing is used in significant accounting applications, internal accounting control procedures may be defined by classifying control procedures into two types: general and
a. Administrative.
b. Specific.
c. Application.
d. Authorization.

M86#31. Of the following statements about an internal accounting control system, which one is correct?
a. The maintenance of the system of internal accounting control is an important responsibility of the internal auditor.
b. Administrative controls relate directly to the safeguarding of assets and the systems of authorization and approval.
c. Because of the cost/benefit relationship, internal accounting control procedures may be applied on a test basis in some circumstances.
d. Internal accounting control procedures reasonably ensure that collusion among employees can not occur.
**Auditing**

**M86#32.** The development of constructive suggestions to clients for improvements in internal accounting control is

a. A requirement of the auditor's study and evaluation of internal accounting control.

b. A desirable by-product of an audit engagement.

c. Addressed by the auditor only during a special engagement.

d. As important as establishing a basis for reliance upon the internal accounting control system.

**M86#53.** An auditor evaluates the existing system of internal accounting control primarily to

a. Ascertain whether employees adhere to managerial policies.

b. Determine the extent of substantive tests that must be performed.

c. Determine whether procedures and records concerning the safeguarding of assets are reliable.

d. Establish a basis for deciding which compliance tests are necessary.

**M85#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.

**M85#16.** 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.

**M85#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.

**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.
Selected Questions

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 information 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.

N84#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#5. The auditor would be least likely to be concerned about internal control as it relates to
a. Land and buildings.
b. Common stock.
c. Shareholder meetings.
d. Minutes of board of directors meetings.

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#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.

N83#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.
Auditing

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.

B. Study and Evaluation of the System

M87#7. Which of the following is least likely to be evidence the auditor examines to determine whether operations are in compliance with the internal accounting control system?
   a. Records documenting usage of EDP programs.
   b. Canceled supporting documents.
   c. Confirmations of accounts receivable.
   d. Signatures on authorization forms.

M87#8. Which of the following most likely constitutes a weakness in the internal accounting control of an EDP system?
   a. The control clerk establishes control over data received by the EDP department and reconciles control totals after processing.
   b. The application programmer identifies programs required by the systems design and flowcharts the logic of these programs.
   c. The systems analyst reviews output and controls the distribution of output from the EDP department.
   d. The accounts payable clerk prepares data for computer processing and enters the data into the computer.
Selected Questions

**M87**

**Item 9** is 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>
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<tbody>
<tr>
<td>Deviation Rate</td>
</tr>
<tr>
<td>Exceeds Tolerable Rate</td>
</tr>
<tr>
<td>Deviation Rate</td>
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<tr>
<td>Less Than Tolerable Rate</td>
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</tbody>
</table>

<p>| Auditor's Estimate       |</p>
<table>
<thead>
<tr>
<th>Based On Sample Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deviation Rate</td>
</tr>
<tr>
<td>Exceeds Tolerable Rate</td>
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<tr>
<td>I.</td>
</tr>
<tr>
<td>Deviation Rate</td>
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<tr>
<td>Less Than Tolerable Rate</td>
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<tr>
<td>II.</td>
</tr>
<tr>
<td>Deviation Rate</td>
</tr>
<tr>
<td>Exceeds Tolerable Rate</td>
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<tr>
<td>III.</td>
</tr>
<tr>
<td>Deviation Rate</td>
</tr>
<tr>
<td>Less Than Tolerable Rate</td>
</tr>
<tr>
<td>IV.</td>
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</tbody>
</table>

9. As a result of compliance testing, the auditor underlies on internal accounting control and thereby increases substantive testing. This is illustrated by situation
   a. I.
   b. II.
   c. III.
   d. IV.

**M87#10.** After completing the preliminary phase of the review of internal accounting control, the auditor decides not to rely on the system to restrict substantive tests. Documentation may be limited to the auditor's
   a. Understanding of the internal accounting control system.
   b. Reasons for deciding not to extend the review.
   c. Basis for concluding that errors and irregularities will be prevented.
   d. Completed internal accounting control questionnaire.

**M87#11.** Based on a study and evaluation completed at an interim date, the auditor concludes that no significant internal accounting control weaknesses exist. The records and procedures would most likely be tested again at year-end if
   a. Compliance tests were not performed by the internal auditor during the remaining period.
   b. The internal accounting control system provides a basis for reliance in reducing the extent of substantive testing.
   c. The auditor used nonstatistical sampling during the interim period compliance testing.
   d. Inquiries and observations lead the auditor to believe that conditions have changed.

**N86#17.** After completing all compliance testing, the auditor should review the results and consider whether
   a. The planned degree of reliance on the internal accounting controls is justified.
   b. The evidential matter obtained from the study of the internal accounting controls can provide a reasonable basis for an opinion.
   c. Further study of the internal accounting controls is likely to justify any restriction of substantive tests.
   d. Sufficient knowledge has been obtained about the entity's entire internal accounting control system.

**N86#19.** After finishing the review of the design of the internal accounting control system in an audit engagement, the auditor should perform compliance tests on
   a. Those controls that have a material effect upon the financial statement balances.
   b. A random sample of the controls that were reviewed.
   c. Those controls that the auditor plans to rely upon.
   d. Those controls in which material weaknesses were identified.

**M86#13.** An auditor plans to examine a sample of 20 purchase orders for proper approvals as prescribed by the client's internal accounting control procedures. One of the purchase orders in the chosen sample of 20 cannot be found, and the auditor is unable to use alternative procedures to test whether that purchase order was properly approved. The auditor should
   a. Choose another purchase order to replace the missing purchase order in the sample.
   b. Consider this compliance test invalid and proceed with substantive tests since internal accounting control can not be relied upon.
   c. Treat the missing purchase order as a deviation for the purpose of evaluating the sample.
   d. Select a completely new set of 20 purchase orders.

**M86#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. A self-checking digit system.
   b. Echo checks.
   c. A computer log.
   d. Computer generated hash totals.
Auditing

M86#21. After the preliminary phase of the review of a client's EDP controls, an auditor may decide not to perform compliance tests related to the control procedures within the EDP portion of the client's internal accounting control system. Which of the following would not be a valid reason for choosing to omit compliance tests?

a. The controls appear adequate.
b. The controls duplicate operative controls existing elsewhere in the system.
c. There appear to be major weaknesses that would preclude reliance on the stated procedure.
d. 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.

M86#25. In a study and evaluation of the system of internal accounting control, the completion of a questionnaire is most closely associated with which of the following?

a. Tests of compliance.
b. Substantive tests.
c. Preliminary evaluation of the system.
d. Review of the system design.

M86#29. If after completing the preliminary phase of the review of the internal accounting control system the auditor plans to rely on the system, the auditor should next

a. Trace several transactions through the related documents and records to observe the related internal accounting control procedures in operation.
b. Perform compliance tests to provide reasonable assurance that the accounting control procedures are being applied as prescribed.
c. Complete the review of the system to determine whether the accounting control procedures are suitably designed.
d. Design substantive tests that contemplate reliance on the system of internal accounting control.

M86#30. Which of the following statistical sampling methods is most useful to auditors when testing for compliance?

a. Ratio estimation.
b. Variable sampling.
c. Difference estimation.
d. Discovery sampling.

M85#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.

M85#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 particular 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.

M85#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.

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.

N84#42. The auditor’s review of the client’s system of internal accounting control is documented in order to substantiate
   a. Conformity of the accounting records with generally accepted accounting principles.
   b. Compliance with generally accepted auditing standards.
   c. Adherence to requirements of management.
   d. The fairness of the financial statement presentation.

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. Increase the extent of both substantive and compliance 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.
   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.

N83#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.

M87#12. For effective internal accounting control, employees maintaining the accounts receivable subsidiary ledger should not also approve
   a. Employee overtime wages.
   b. Credit granted to customers.
   c. Write-offs of customer accounts.
   d. Cash disbursements.

M87#13. The completeness of EDP-generated sales figures can be tested by comparing the number of items listed on the daily sales report with the number of items billed on the actual invoices. This process uses
   a. Check digits.
   b. Control totals.
   c. Validity tests.
   d. Process tracing data.

M87#14. An internal accounting 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 cancelled checks and ascertain that the related receiving reports are dated no earlier than the checks.
   b. Select and examine cancelled checks and ascertain that the related receiving reports are dated no later than the checks.
   c. Select and examine receiving reports and ascertain that the related cancelled checks are dated no earlier than the receiving reports.
   d. Select and examine receiving reports and ascertain that the related cancelled checks are dated no later than the receiving reports.

M87#15. In a properly designed internal accounting control system, the same employee may be permitted to
   a. Receive and deposit checks, and also approve write-offs of customer accounts.
   b. Approve vouchers for payment, and also sign checks.
   c. Reconcile the bank statements, and also receive and deposit cash.
   d. Sign checks, and also cancel supporting documents.

M87#16. Instead of taking a physical inventory count on the balance-sheet date the client may take physical counts prior to the year-end if internal accounting controls are adequate and
   a. Computerized records of perpetual inventory are maintained.
   b. Inventory is slow-moving.
   c. EDP error reports are generated for missing prenumbered inventory tickets.
   d. Obsolete inventory items are segregated and excluded.

M87#17. Which of the following internal accounting control procedures could best prevent direct labor from being charged to manufacturing overhead?
   a. Reconciliation of work in process inventory with cost records.
   b. Comparison of daily journal entries with factory labor summary.
   c. Comparison of periodic cost budgets and time cards.
   d. Reconciliation of unfinished job summary and production cost records.

M87#18. The purpose of segregating the duties of hiring personnel and distributing payroll checks is to separate the
   a. Operational responsibility from the record keeping responsibility.
   b. Responsibilities of recording a transaction at its origin from the ultimate posting in the general ledger.
   c. Authorization of transactions from the custody of related assets.
   d. Human resources function from the controllership function.
Selected Questions

M87#20. The auditor may observe the distribution of paychecks to ascertain whether
a. Payrate authorization is properly separated from the operating function.
b. Deductions from gross pay are calculated correctly and are properly authorized.
c. Employees of record actually exist and are employed by the client.
d. Paychecks agree with the payroll register and the time cards.

M87#21. A weakness in internal accounting control over recording retirements of equipment may cause the auditor to
a. Inspect certain items of equipment in the plant and trace those items to the accounting records.
b. Review the subsidiary ledger to ascertain whether depreciation was taken on each item of equipment during the year.
c. Trace additions to the "other assets" account to search for equipment that is still on hand but no longer being used.
d. Select certain items of equipment from the accounting records and locate them in the plant.

M87#22. When there are few property and equipment transactions during the year, the continuing auditor usually makes a
a. Complete review of the related internal accounting controls and performs compliance tests of those controls being relied upon.
b. Complete review of the related internal accounting controls and performs analytical review tests to verify current year additions to property and equipment.
c. Preliminary review of the related internal accounting controls and performs a thorough examination of the balances at the beginning of the year.
d. Preliminary review of the related internal accounting controls and performs extensive tests of current year property and equipment transactions.

M86#22. 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.
d. Sales invoice file.

M86#23. For the accounting system of Acme Company the amounts of cash disbursements entered into an EDP terminal are transmitted to the computer that immediately transmits the amounts back to the terminal for display on the terminal screen. This display enables the operator to
a. Establish the validity of the account number.
b. Verify the amount was entered accurately.
c. Verify the authorization of the disbursement.
d. Prevent the overpayment of the account.

M86#24. Which of the following is a question that the auditor would expect to find on the production cycle section of an internal accounting control questionnaire?
 a. Are vendors' invoices for raw materials approved for payment by an employee who is independent of the cash disbursements function?
b. Are signed checks for the purchase of raw materials mailed directly after signing without being returned to the person who authorized the invoice processing?
c. Are all releases by storekeepers of raw materials from storage based on approved requisition documents?
d. Are details of individual disbursements for raw materials balanced with the total to be posted to the appropriate general ledger account?

M86#21. Matthews Corp. has changed from a system of recording time worked on clock cards to a computerized payroll system in which employees record time in and out with magnetic cards. The EDP system automatically updates all payroll records. Because of this change
a. A generalized computer audit program must be used.
b. Part of the audit trail is altered.
c. The potential for payroll related fraud is diminished.
d. Transactions must be processed in batches.

M86#38. Alpha Company uses its sales invoices for posting perpetual inventory records. Inadequate internal accounting controls over the invoicing function allow goods to be shipped that are not invoiced. The inadequate controls could cause an
a. Understatement of revenues, receivables, and inventory.
b. Overstatement of revenues and receivables, and an understatement of inventory.
c. Understatement of revenues and receivables, and an overstatement of inventory.
d. Overstatement of revenues, receivables, and inventory.

M86#39. In a properly designed accounts payable system, a voucher is prepared after the invoice, purchase order, requisition, and receiving report are verified. The next step in the system is to
a. Cancel the supporting documents.
b. Enter the check amount in the check register.
c. Approve the voucher for payment.
d. Post the voucher amount to the expense ledger.
**Auditing**

**M86#40.** Sound internal accounting control procedures dictate that defective merchandise returned by customers should be presented to the
a. Purchasing clerk.
b. Receiving clerk.
c. Inventory control clerk.
d. Sales clerk.

**M86#41.** If, after completing the review of the design of internal accounting controls, the auditor plans to rely on internal accounting control procedures pertaining to plant asset transactions, the auditor should next
a. Make extensive substantive tests of plant asset balances.
b. Establish the physical existence of current year additions.
c. Complete the plant asset section of the internal accounting control questionnaire.
d. Perform compliance tests of the controls expected to be relied upon.

**M86#45.** To achieve good internal accounting control which department should perform the activities of matching shipping documents with sales orders and preparing daily sales summaries?
b. Shipping.
c. Credit.
d. Sales order.

**M86#58.** A small client recently put its cash disbursements system on a microcomputer. About which of the following internal accounting control features would an auditor most likely be concerned?
a. Programming of this microcomputer is in BASIC, although COBOL is the dominant, standard language for business processing.
b. This microcomputer is operated by employees who have other, non-data-processing job responsibilities.
c. The microcomputer terminal is physically close to the computer and directly connected to it.
d. There are restrictions on the amount of data that can be stored and on the length of time that data can be stored.

**N85#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.

**N85#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.

**N85#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.

**N85#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.

**N85#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.

**M85#99.** 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.
Selected Questions

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.

c. Continuous utilization of serially numbered retirement work orders.
d. Periodic inspection of insurance policies by the internal auditors.

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 collateralization.
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.

M84#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.

M84#34. The auditor is most likely to seek information from the plant manager with respect to the
a. Adequacy of the provision for uncollectible accounts.
b. Appropriateness of physical inventory observation procedures.
c. Existence of obsolete machinery.
d. Deferral of procurement of certain necessary insurance coverage.

M84#47. In a properly designed internal accounting control system, the same employee should not be permitted to
a. Sign checks and cancel supporting documents.
b. Receive merchandise and prepare a receiving report.
c. Prepare disbursement vouchers and sign checks.
d. Initiate a request to order merchandise and approve merchandise received.
Auditing

M84#48. The proper use of prenumbered termination notice forms by the payroll department should provide assurance that all
a. Uncashed payroll checks were issued to employees who have not been terminated.
b. Personnel files are kept up to date.
c. Employees who have not been terminated receive their payroll checks.
d. Terminated employees are removed from the payroll.

M84#56. 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)
a. Shipping order.
b. Material requisition.
c. Bill of lading.
d. Inspection report.

M83#4. Hitech, 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
a. The auditor must audit through the computer.
b. Internal control has improved.
c. Part of the audit trail has been lost.
d. The potential for payroll-related fraud has been diminished.

M83#6. From the auditor's point of view, inventory counts are more acceptable prior to the year-end when
a. Internal control is weak.
b. Accurate perpetual inventory records are maintained.
c. Inventory is slow-moving.
d. Significant amounts of inventory are held on a consignment basis.

M83#22. 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. A control total for hours worked, prepared from time cards collected by the timekeeping department.
b. 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.
c. Use of a check digit for employee numbers.
d. Use of a header label for the payroll input sheet.

M83#38. The least crucial element of internal control over cash is
a. Separation of cash record keeping from custody of cash.
b. Preparation of the monthly bank reconciliation.
c. Batch processing of checks.
d. 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.
D. Other Considerations

**M87#19.** The auditor's communication of material weaknesses in internal accounting control is

a. Required to enable the auditor to state that the examination has been made in accordance with generally accepted auditing standards.

b. The principal reason for studying and evaluating the system of internal accounting controls.

c. Incident to the auditor's objective of forming an opinion as to the fair presentation of the financial statements.

d. Required to be documented in a written report to the board of directors or the board's audit committee.

**M87**

Items 24 through 26 are based on the following section of a system flowchart for a payroll application

![System Flowchart]

26. Symbol C could represent

a. Batched time cards.

b. Unclaimed payroll checks.

c. Erroneous time cards.

d. An error report.

**N86#20.** When performing a compliance test with respect to control over cash receipts, an auditor 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 systematically replaced in the population after sampling.

b. May systematically occur more than once in the sample.

c. Must be recorded in a systematic pattern before the sample can be drawn.

d. May occur in a systematic pattern, thus destroying the sample randomness.

**N86#21.** In the examination of the financial statements of Delta Company, the auditor determines that in performing a compliance test of internal accounting control, the compliance rate in the sample does not support the planned degree of reliance on the control when, in fact, the compliance rate in the population does justify such reliance. This situation illustrates the risk of

a. Overreliance.

b. Underreliance.

c. Incorrect rejection.

d. Incorrect acceptance.

**N86#27.** Which of the following statements with respect to the auditor's required communication of a material weakness in internal accounting control is correct?

a. A weakness discovered should be compliance tested by the auditor before being communicated to the client.

b. Suggested corrective action for management's consideration with respect to a weakness need not be communicated to the client.

c. A weakness previously communicated during prior years' audits that has not been corrected need not be communicated again.

d. The communication of a weakness for which management believes corrective action is not practicable should be included in a separate paragraph of the auditor's report.

**M86#7.** The accountant's report expressing an opinion on an entity's system of internal accounting control would not include

a. Brief explanation of the broad objectives and inherent limitations of internal accounting control.

b. Specific date that the report covers, rather than a period of time.

c. Statement that the entity's system of internal accounting control is consistent with that of the prior year after giving effect to subsequent changes.

d. Description of the scope of the engagement.
**Auditing**

**M86#46.** What is the continuing auditor's obligation concerning the discovery at an interim date of a material weakness in the internal accounting control of a client if this same weakness had been communicated to the client during the prior year's audit?
   a. The auditor should communicate this weakness to the client immediately because the discovery of such weaknesses in internal accounting control is the purpose of a review of interim financial information.
   b. The auditor need not communicate this weakness to the client because it had already been communicated the prior year.
   c. The auditor should communicate this weakness to the client following completion of the examination unless the auditor decides to communicate it to the client at the interim date.
   d. The auditor should extend the audit procedures to investigate whether this weakness had any effect on the prior year's financial statements.

**M86#47.** Which of the following flowchart symbols represents online storage?

- a. [Flowchart A]
- b. [Flowchart B]
- c. [Flowchart C]
- d. [Flowchart D]

**M85#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.

**M85#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.

**M85#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.

**N85 Item 38** is 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>
</tr>
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<tbody>
<tr>
<td></td>
<td>Exceeds Tolerable Rate</td>
<td>is Less Than Tolerable Rate</td>
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<table>
<thead>
<tr>
<th>Auditor's Estimate Based On Sample Results</th>
<th>Deviation Rate Exceeds Tolerable Rate</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>I.</td>
</tr>
<tr>
<td></td>
<td>II.</td>
</tr>
<tr>
<td>Deviation Rate is Less Than Tolerable Rate</td>
<td>III.</td>
</tr>
<tr>
<td></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.

M85#60. Which of the following symbolic representations indicates that a sales invoice has been filed?

   a. ![Symbolic representation 1]
   b. ![Symbolic representation 2]
   c. ![Symbolic representation 3]
   d. ![Symbolic representation 4]

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#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.

M84#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.

M84#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.

M84#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#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.
Auditing

M83#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.

M83#2. The tolerable rate of deviations for a compliance test is generally
a. Lower than the expected rate of errors in the related accounting records.

M83#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.

M83#6. Which of the following best illustrates the concept of sampling risk?
(a) A randomly chosen sample may be representative of the population as a whole on the characteristic of interest.

M83#3. An auditor examining inventory may appropriately apply sampling for attributes in order to estimate the
a. Average price of inventory items.

M83#32. 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.

M83#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.

N83#7. Which of the following is an element of sampling risk?
(a) Choosing an audit procedure that is inconsistent with the audit objective.

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.

N83#54. Which of the following symbolic representations indicate that a file has been consulted?

(a) 

(b) 

c. 

d. 

A-26
Selected Questions

III. Evidence and Procedures

A. Audit Evidence

M87#3. An abnormal fluctuation in gross profit that might suggest the need for extended audit procedures for sales and inventories would most likely be identified in the planning phase of the audit by the use of
   a. Tests of transactions and balances.
   b. A preliminary review of internal accounting control.
   c. Specialized audit programs.
   d. Analytical review procedures.

M87#23. When there are a large number of relatively small account balances, negative confirmation of accounts receivable is feasible if internal accounting control is
   a. Strong, and the individuals receiving the confirmation requests are unlikely to give them adequate consideration.
   b. Weak, and the individuals receiving the confirmation requests are likely to give them adequate consideration.
   c. Weak, and the individuals receiving the confirmation requests are unlikely to give them adequate consideration.
   d. Strong, and the individuals receiving the confirmation requests are likely to give them adequate consideration.

M87#27. Audit evidence can come in different forms with different degrees of persuasiveness. Which of the following is the least persuasive type of evidence?
   a. Bank statement obtained from the client.
   b. Computations made by the auditor.
   c. Prenumbered client sales invoices.
   d. Vendor's invoice.

M87#28. An example of an analytical review procedure is the comparison of
   a. Financial information with similar information regarding the industry in which the entity operates.
   b. Recorded amounts of major disbursements with appropriate invoices.
   c. Results of a statistical sample with the expected characteristics of the actual population.
   d. EDP generated data with similar data generated by a manual accounting system.

M87#30. When auditing merchandise inventory at year-end, the auditor performs a purchase cutoff test to obtain evidence that
   a. All goods purchased before year-end are received before the physical inventory count.
   b. No goods held on consignment for customers are included in the inventory balance.
   c. No goods observed during the physical count are pledged or sold.
   d. All goods owned at year-end are included in the inventory balance.

M87#31. Which of the following is the most effective audit procedure for verification of dividends earned on investments in marketable equity securities?
   a. Tracing deposit of dividend checks to the cash receipts book.
   b. Reconciling amounts received with published dividend records.
   c. Comparing the amounts received with preceding year dividends received.
   d. Recomputing selected extensions and footings of dividend schedules and comparing totals to the general ledger.

M87#32. Which of the following auditing procedures is ordinarily performed last?
   a. Obtaining a management representation letter.
   b. Testing the purchasing function.
   c. Reading the minutes of directors' meetings.
   d. Confirming accounts payable.

M87#46. Which of the following statements concerning the auditor's use of the work of a specialist is correct?
   a. If the specialist is related to the client, the auditor is not permitted to use the specialist's findings as corroborative evidence.
   b. The specialist may be identified in the auditor's report only when the auditor issues a qualified opinion.
   c. The specialist should have an understanding of the auditor's corroborative use of the specialist's findings.
   d. If the auditor believes that the determinations made by the specialist are unreasonable, only an adverse opinion may be issued.

M86#2. When using the work of a specialist, the auditor may make reference to and identification of the specialist in the auditor's report if the
   a. Auditor decides to express a qualified opinion.
   b. Specialist's reputation or professional certification is being emphasized.
   c. Auditor wishes to indicate a division of responsibility.
   d. Specialist's work provides the auditor greater assurance of reliability.
Auditng

N86#25. A basic premise underlying analytical review procedures is that
   a. Statistical tests of financial information may lead to the discovery of material errors in the financial statements.
   b. The study of financial ratios is an acceptable alternative to the investigation of unusual fluctuations.
   c. Relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.
   d. These procedures can not replace tests of balances and transactions.

N86#28. The auditor’s analytical review will be facilitated if the client
   a. Uses a standard cost system that produces variance reports.
   b. Segregates obsolete inventory before the physical inventory count.
   c. Corrects material weaknesses in internal accounting control before the beginning of the audit.
   d. Reduces inventory balances to the lower of cost or market.

N86#29. Which of the following audit procedures would provide the least reliable evidence that the client has legal title to inventories?
   a. Confirmation of inventories at locations outside the client’s facilities.
   b. Analytical review of inventory balances compared to purchasing and sales activities.
   c. Observation of physical inventory counts.
   d. Examination of paid vendors’ invoices.

N86#30. An aged trial balance of accounts receivable is usually used by the auditor to
   a. Verify the validity of recorded receivables.
   b. Ensure that all accounts are promptly credited.
   c. Evaluate the results of compliance tests.
   d. Evaluate the provision for bad debt expense.

N86#31. When an auditor is unable to inspect and count a client’s investment securities until after the balance-sheet date, the bank where the securities are held in a safe deposit box should be asked to
   a. Verify any differences between the contents of the box and the balances in the client’s subsidiary ledger.
   b. Provide a list of securities added and removed from the box between the balance-sheet date and the security-count date.
   c. Confirm that there has been no access to the box between the balance-sheet date and the security-count date.
   d. Count the securities in the box so the auditor will have an independent direct verification.

N86#32. Hall accepted an engagement to audit the 1985 financial statements of XYZ Company. XYZ completed the preparation of the 1985 financial statements on February 13, 1986, and Hall began the field work on February 17, 1986. Hall completed the field work on March 24, 1986, and completed the report on March 28, 1986. The client’s representation letter normally would be dated
   b. February 17, 1986.

N86#34. The auditor’s primary means of obtaining corroboration of management’s information concerning litigation is a
   a. Letter of audit inquiry to the client’s lawyer.
   b. Letter of corroboration from the auditor’s lawyer upon review of the legal documentation.
   c. Confirmation of claims and assessments from the other parties to the litigation.
   d. Confirmation of claims and assessments from an officer of the court presiding over the litigation.

N86#47. 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. Analytical review procedures.
   b. Auditor working papers.
   c. Review of the system of internal accounting control.
   d. Proper planning of the audit engagement.

M86#2. Purchase cutoff procedures should be designed to test whether or not all inventory
   a. Purchased and received before the end of the year was paid for.
   b. Ordered before the end of the year was received.
   c. Purchased and received before the end of the year was recorded.
   d. Owned by the company is in the possession of the company at the end of the year.

M86#5. The primary reason an auditor requests letters of inquiry be sent to a client’s attorneys is to provide the auditor with
   a. A description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet.
   b. An expert opinion as to whether a loss is possible, probable, or remote.
   c. The opportunity to examine the documentation concerning litigation, claims, and assessments.
   d. Corroboration of the information furnished by management concerning litigation, claims, and assessments.
Selected Questions

M86#33. An auditor compares 1985 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. Fourth quarter payroll taxes were not paid.
   c. An increase in property tax rates has not been recognized in the client’s accrual.
   d. The 1985 provision for uncollectible accounts is inadequate because of worsening economic conditions.

M86#34. The auditor may conclude that depreciation charges are insufficient by noting
a. Large amounts of fully depreciated assets.
   b. Continuous trade-ins of relatively new assets.
   c. Excessive recurring losses on assets retired.
   d. Insured values greatly in excess of book values.

M86#48. When an examination is made in accordance with generally accepted auditing standards, the auditor should always
a. Document the auditor’s understanding of the client’s internal accounting control system.
   b. Employ analytical review procedures.
   c. Obtain certain written representations from management.
   d. Observe the taking of physical inventory on the balance sheet date.

N85

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.

On July 18, 1984, William Cream hired the CPA firm of Part & Co. to audit Hickory’s financial statements for the year ended December 31, 1984. Part & Co. performed the audit field work from December 15, 1984, through March 10, 1985.

Part & Co. has offices in Cleveland, the office that performed the Hickory audit, and Chicago.

22. Hickory’s client representation letter should be dated

N85#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.

N85#41. Smith is engaged in the audit of a cable TV firm which services 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.

N85#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.

N85#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.

N85#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.
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.

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.
\textbf{Selected Questions}

\textbf{M84\#40.} The auditor can best verify a client’s bond sinking fund transactions and year-end balance by
\begin{enumerate}[a.]
    \item Confirmation with individual holders of retired bonds,
    \item Confirmation with the bond trustee,
    \item Recomputation of interest expense, interest payable, and amortization of bond discount or premium,
    \item Examination and count of the bonds retired during the year.
\end{enumerate}

\textbf{M84\#56.} If a lawyer refuses to furnish corroborating information regarding litigation, claims, and assessments, the auditor should
\begin{enumerate}[a.]
    \item Honor the confidentiality of the client-lawyer relationship,
    \item Consider the refusal to be tantamount to a scope limitation,
    \item Seek to obtain the corroborating information from management,
    \item Disclose this fact in a footnote to the financial statements.
\end{enumerate}

\textbf{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
\begin{enumerate}[a.]
    \item Substantive tests,
    \item Compliance tests,
    \item Internal control,
    \item Statistical analysis.
\end{enumerate}

\textbf{M84\#6.} In the confirmation of accounts receivable the auditor would most likely
\begin{enumerate}[a.]
    \item Request confirmation of a sample of the inactive accounts,
    \item Seek to obtain positive confirmations for at least 50% of the total dollar amount of the receivables,
    \item Require confirmation of all receivables from agencies of the federal government,
    \item Require that confirmation requests be sent within one month of the fiscal year-end.
\end{enumerate}

\textbf{M84\#19.} Auditors may use positive and/or negative forms of confirmation requests for accounts receivable. An auditor most likely will use
\begin{enumerate}[a.]
    \item The positive form to confirm all balances regardless of size,
    \item A combination of the two forms, with the positive form used for large balances and the negative form for the small balances,
    \item A combination of the two forms, with the positive form used for trade receivables and the negative form for other receivables,
    \item The positive form when controls related to receivables are satisfactory, and the negative form when controls related to receivables are unsatisfactory.
\end{enumerate}

\textbf{M84\#22.} An auditor should obtain written representations 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
\begin{enumerate}[a.]
    \item The auditor and the client’s lawyer,
    \item Management and the auditor,
    \item Management, the client’s lawyer, and the auditor,
    \item The auditor independently of management.
\end{enumerate}

\textbf{M84\#23.} Of the following which is the least persuasive type of audit evidence?
\begin{enumerate}[a.]
    \item Documents mailed by outsiders to the auditor,
    \item Correspondence between auditor and vendors,
    \item Copies of sales invoices inspected by the auditor,
    \item Computations made by the auditor.
\end{enumerate}

\textbf{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
\begin{enumerate}[a.]
    \item Document management’s intentions with respect to plans for reversing this trend,
    \item Evaluate management’s performance in causing this decline,
    \item Require footnote disclosure,
    \item Consider the possibility of an error in the financial statements.
\end{enumerate}

\textbf{M84\#27.} The auditor notices significant fluctuations in key elements of the company’s financial statements. If management is unable to provide an acceptable explanation, the auditor should
\begin{enumerate}[a.]
    \item Consider the matter a scope limitation,
    \item Perform additional audit procedures to investigate the matter further,
    \item Intensify the examination with the expectation of detecting management fraud,
    \item Withdraw from the engagement.
\end{enumerate}
M84#29. Analytical review procedures are
a. Substantive tests designed to evaluate a system of internal control.
b. Compliance tests designed to evaluate the validity of management's representation letter.
c. Substantive tests designed to evaluate the reasonableness of financial information.
d. Compliance tests designed to evaluate the reasonableness of financial information.

c. Obtaining corroboration of information furnished by the client.
d. Identifying impaired assets and incurred liabilities.

M84#31. The auditor may refer to and identify a specialist 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 independent 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 furnish certain requested information would most likely be considered
a. A limitation in the scope of the auditor's examination.
b. Indicative of the existence of material unasserted loss contingencies.
c. A characteristic of untrustworthy management.
d. Evidence of an inability to formulate an opinion regarding the outcome of pending litigation.

M84#60. The letter of inquiry that is ordinarily sent to lawyers with whom management consulted concerning 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.
comments. By this procedure the auditor would be most likely to learn of which of the following?
   a. One of the cashiers has been covering a personal embezzlement by lapping.
   b. One of the sales clerks has not been preparing charge slips for credit sales to family and friends.
   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 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 was 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.

N83#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.

N83#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, 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.
M38#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.

M38#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.

M38#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.

M38#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.

M38#50. A client’s physical count of inventories was higher than the inventory quantities per the perpetual records. This situation could be the result of the failure to record
a. Sales.
b. Sales discounts.
c. Purchases.
d. Purchase returns.

M38#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.

M38#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.

B. Specific Audit Objectives and Procedures

M87#36. On receiving the bank cutoff statement, the auditor should trace
a. Deposits in transit on the year-end bank reconciliation to deposits in the cash receipts journal.
b. Checks dated prior to year-end to the outstanding checks listed on the year-end bank reconciliation.
c. Deposits listed on the cutoff statement to deposits in the cash receipts journal.
d. Checks dated subsequent to year-end to the outstanding checks listed on the year-end bank reconciliation.

M87#37. An auditor ordinarily should send a standard confirmation request to all banks with which the client has done business during the year under audit, regardless of the year-end balance, because this procedure
a. Provides for confirmation regarding compensating balance arrangements.
b. Detects kiting activities that may otherwise not be discovered.
c. Seeks information about indebtedness to the bank.
d. Verifies securities held by the bank in safekeeping.
Selected Questions

M87#38. Which of the following is the best audit procedure for determining the existence of unrecorded liabilities at year-end?
   a. Examine a sample of invoices dated a few days prior to and subsequent to year-end to ascertain whether they have been properly recorded.
   b. Examine a sample of cash disbursements in the period subsequent to year-end.
   c. Examine confirmation requests returned by creditors whose accounts appear on a subsidiary trial balance of accounts payable.
   d. Examine unusual relationships between monthly accounts payable balances and recorded purchases.

M87#43. Working papers that record the procedures used by the auditor to gather evidence should be
   a. Considered the primary support for the financial statements being examined.
   b. Viewed as the connecting link between the books of account and the financial statements.
   c. Designed to meet the circumstances of the particular engagement.
   d. Destroyed when the audited entity ceases to be a client.

M86#38. An auditor would be most likely to identify a contingent liability by obtaining a(An)
   a. Related party transaction confirmation.
   b. Accounts payable confirmation.
   c. Transfer agent confirmation.
   d. Standard bank confirmation.

M86#39. Which of the following might be detected by an auditor’s review of the client’s sales cut-off?
   a. Excessive goods returned for credit.
   b. Unrecorded sales discounts.
   c. Lapping of year-end accounts receivable.
   d. Inflated sales for the year.

M86#43. Confirmation is most likely to be a relevant form of evidence with regard to assertions about accounts receivable when the auditor has concerns about the receivables’
   a. Valuation.
   b. Classification.
   c. Existence.
   d. Completeness.

M86#42. The permanent file section of the working papers that is kept for each audit client most likely contains
   a. Review notes pertaining to questions and comments regarding the audit work performed.
   b. A schedule of time spent on the engagement by each individual auditor.
   c. Correspondence with the client’s legal counsel concerning pending litigation.
   d. Narrative descriptions of the client’s accounting procedures and internal accounting controls.

M85#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.

M85#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.

M85#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.

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.

N84/#47. The auditor will most likely perform extensive tests for possible understatement of
 a. Revenues.
 b. Assets.
 c. Liabilities.
 d. Capital.

M84/#12. 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.

M84/#49. 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.

N83/#20. 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.

M83/#12. 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.

M83/#24. 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.

M83/#42. 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.

C. Other Specific Audit Topics

M87/#33. After discovering that a related party transaction exists, the auditor should be aware that the
 a. Substance of the transaction could be significantly different from its form.
 b. Adequacy of disclosure of the transaction is secondary to its legal form.
 c. Transaction is assumed to be outside the ordinary course of business.
 d. Financial statements should recognize the legal form of the transaction rather than its substance.

M87/#39. Operational auditing is primarily oriented toward
 a. Future improvements to accomplish the goals of management.
 b. The accuracy of data reflected in management's financial records.
 c. The verification that a company's financial statements are fairly presented.
 d. Past protection provided by existing internal accounting control.

M87/#44. Which of the following is not a major reason why an accounting audit trail should be maintained for a computer system?
 a. Query answering.
 b. Deterrent to irregularities.
 c. Monitoring purposes.
 d. Analytical review.

M87/#45. When using a computer to gather evidence, the auditor need not have working knowledge of the client's programming language. However, it is necessary that the auditor understand the
 a. Audit specifications.
 b. Programming techniques.
 c. Database retrieval system.
 d. Manual testing techniques.

M87/#47. An auditor concludes that an audit procedure considered necessary at the time of the examination had been omitted. The auditor should assess the importance of the omitted procedure to the ability to
support the previously expressed opinion. Which of the following would be least helpful in making that assessment?

a. A discussion with the client about whether there are persons relying on the auditor’s report.

b. A reevaluation of the overall scope of the examination.

c. A discussion of the circumstances with engagement personnel.

d. A review of the other audit procedures that were applied that might compensate for the one omitted.

**N86#48.** A client acquired 25% of its outstanding capital stock after year-end and prior to completion of the auditor’s fieldwork. The auditor should

a. Advise management to adjust the balance sheet to reflect the acquisition.

b. Issue pro forma financial statements giving effect to the acquisition as if it had occurred at year-end.

c. Advise management to disclose the acquisition in the notes to the financial statements.

d. Disclose the acquisition in the opinion paragraph of the auditor’s report.

**N86#35.** The least likely use by the auditor of generalized audit software is to

a. Perform analytical review on the client’s data.

b. Access the information stored on the client’s EDP files.

c. Identify weaknesses in the client’s EDP controls.

d. Test the accuracy of the client’s computations.

**N86#36.** Processing simulated file data provides the auditor with information about the reliability of controls from evidence that exists in simulated files. One of the techniques involved in this approach makes use of

a. Controlled reprocessing.

b. Program code checking.

c. Printout reviews.

d. Integrated test facility.

**N86#37.** Which of the following sampling plans would be designed to estimate a numerical measurement of a population, such as a dollar value?

a. Discovery sampling.

b. Numerical sampling.

c. Sampling for variables.

d. Sampling for attributes.

**N86#40.** An auditor issued an audit report that was dual dated for a subsequent event occurring after the completion of field work but before issuance of the auditor’s report. The auditor’s responsibility for events occurring subsequent to the completion of field work was

a. Limited to the specific event referenced.

b. Limited to include only events occurring before the date of the last subsequent event referenced.

c. Extended to subsequent events occurring through the date of issuance of the report.

d. Extended to include all events occurring since the completion of field work.

**N86#41.** After issuing a report an auditor concludes that an auditing procedure considered necessary at the time of the examination was omitted from the examination. The auditor should first

a. Undertake to apply the omitted procedure or alternative procedures that would provide a satisfactory basis for the auditor’s opinion.

b. Assess the importance of the omitted procedure to the auditor’s ability to support the opinion expressed on the financial statements taken as a whole.

c. Notify the audit committee or the board of directors that the auditor’s opinion can no longer be relied upon.

d. Review the results of other procedures that were applied to compensate for the one omitted or to make its omission less important.

**N86#44.** Auditors who prefer statistical sampling to nonstatistical sampling may do so because statistical sampling helps the auditor

a. Measure the sufficiency of the evidential matter obtained.

b. Eliminate subjectivity in the evaluation of sampling results.

c. Reduce the level of tolerable error to a relatively low amount.

d. Minimize the failure to detect a material misstatement due to nonsampling risk.

**N86#49.** An auditor would be most likely to consider expressing a qualified opinion if the client’s financial statements include a footnote on related party transactions that

a. Lists the amounts due from related parties including the terms and manner of settlement.

b. Discloses compensating balance arrangements maintained for the benefit of related parties.

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.
Auditing

M86#43. An auditor is concerned with completing various phases of the examination after the balance-sheet date. This "subsequent period" extends to the date of the
   a. Auditor's report.
   b. Final review of the audit working papers.
   c. Public issuance of the financial statements.
   d. Delivery of the auditor's report to the client.

M86#44. A primary advantage of using generalized audit software packages in auditing the financial statements of a client that uses an EDP system is that the auditor may
   a. Substantiate the accuracy of data through self-checking digits and hash totals.
   b. Access information stored on computer files without a complete understanding of the client's hardware and software features.
   c. Reduce the level of required compliance testing to a relatively small amount.
   d. Gather and permanently store large quantities of supportive evidential matter in machine readable form.

M86#54. Which of the following audit procedures would an auditor be least likely to perform using a generalized computer audit program?
   a. Searching records of accounts receivable balances for credit balances.
   b. Investigating inventory balances for possible obsolescence.
   c. Selecting accounts receivable for positive and negative confirmation.
   d. Listing of unusually large inventory balances.

N85#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.

N85#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.

N85#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.

N85#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.

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.

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.
Selected Questions

N85#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 designed 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.

N85#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.

N85#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.

N85#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.

N85#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.

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 sub-

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Auditing

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>AR</th>
<th>IC</th>
<th>UR</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>40%</td>
<td>10%</td>
</tr>
<tr>
<td>20%</td>
<td>60%</td>
<td>5%</td>
</tr>
<tr>
<td>10%</td>
<td>70%</td>
<td>4½%</td>
</tr>
<tr>
<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 4,100</td>
<td>$5,000,000</td>
<td>?</td>
</tr>
<tr>
<td>Sample 200</td>
<td>$250,000</td>
<td>$300,000</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#7. Statistical sampling provides a technique for

a. Exactly defining materiality.
b. Greatly reducing the amount of substantive testing.
c. Eliminating judgment in testing.
d. Measuring the sufficiency of evidential matter.

M84#21. The theoretical distribution of means from all possible samples of a given size is a normal distribution and this distribution is the basis for statistical sampling. Which of the following statements is not true with respect to the sampling distribution of sample means?

a. Approximately 68% of the sample means will be within one standard deviation of the mean for the normal distribution.
b. The distribution is defined in terms of its mean and its standard error of the mean.
c. An auditor can be approximately 95% confident that the mean for a sample is within two standard deviations of the population mean.
d. The items drawn in an auditor’s sample will have a normal distribution.

M84#30. In examining cash disbursements, an auditor plans to choose a sample using systematic selection with a random start. The primary advantage of such a systematic selection is that population items

a. Which include irregularities will not be overlooked when the auditor exercises compatible reciprocal options.
b. May occur in a systematic pattern, thus making the sample more representative.
c. May occur more than once in a sample.
d. Do not have to be prenumbered in order for the auditor to use the technique.

M84#46. 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.
Selected Questions

**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.

**M83#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.

**M83#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>Measure of</th>
<th>Error frequency is</th>
</tr>
</thead>
<tbody>
<tr>
<td>tolerable error is</td>
<td>expected to be</td>
</tr>
<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.

**D. Review and Compilation Procedures**

**M87#34.** Prior to commencing the compilation of financial statements of a nonpublic entity, the accountant
should
a. Perform analytical review procedures sufficient to determine whether fluctuations among account balances appear reasonable.
b. Complete the preliminary phase of the study and evaluation of the entity's internal accounting control.
c. Verify that the financial information supplied by the entity agrees with the books of original entry.
d. Acquire a knowledge of any specialized accounting principles and practices used in the entity's industry.

**M87#35.** Which of the following would the accountant most likely investigate during the review of financial
statements of a nonpublic entity if accounts receivable did not conform to a predictable pattern during the
year?
  a. Sales returns and allowances.
b. Credit sales.
c. Sales of consigned goods.
d. Cash sales.

**N86#26.** Which of the following procedures is usually included in a review engagement of a nonpublic entity?
  a. The confirmation of accounts receivable.
b. A study and evaluation of internal accounting control.
c. An inquiry concerning subsequent events.
d. The observation of physical inventory counts.

**N86#42.** Before performing a compilation of the financial statements of a nonpublic entity, an accountant
should
a. Perform a thorough study and evaluation of the internal accounting control system.
b. Complete a series of inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions.
c. Design working papers intended to provide sufficient competent evidential matter to afford a reasonable basis for a compilation opinion.
d. Obtain an understanding of the accounting principles and practices of the industry in which the entity operates.
Auditing

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

M87/#40. A limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion will always result when management
   a. Prevents the auditor from reviewing the working papers of the predecessor auditor.
   b. Engages the auditor after the year-end physical inventory count is completed.
   c. Fails to correct a material internal accounting control weakness that had been identified during the prior year's audit.
   d. Refuses to furnish a management representation letter to the auditor.

M87/#41. If there were no changes during the reporting period in the application of accounting principles, which of the following types of opinions should omit any reference to consistency?
   a. "Except for" qualified opinion.
   b. Unqualified opinion.
   c. "Subject to" qualified opinion.
   d. Adverse opinion.

M87/#42. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express either an
   a. "Except for" qualified opinion or an adverse opinion.
   b. Adverse opinion or a "subject to" qualified opinion.
   c. "Subject to" qualified opinion or an unqualified opinion with a separate explanatory paragraph.
   d. Unqualified opinion with a separate explanatory paragraph or an "except for" qualified opinion.

M87/#50. When an auditor qualifies an opinion because of a scope limitation, which paragraph(s) of the auditor's report should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself?
   a. The scope paragraph and the separate explanatory paragraph.
   b. The separate explanatory paragraph and the opinion paragraph.
   c. The scope paragraph only.
   d. The opinion paragraph only.

M87/#51. The management of a client company believes that the statement of changes in financial position (statement of cash flows) 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. Adverse.
   b. Unqualified.
   c. Qualified due to inadequate disclosure.
   d. Qualified due to a scope limitation.

M87/#53. The auditor would most likely issue a disclaimer of opinion because of
   a. The client's failure to present supplementary information required by the FASB.
   b. Inadequate disclosure of material information.
   c. A client-imposed scope limitation.
   d. The qualification of an opinion by the other auditor of a subsidiary where there is a division of responsibility.

M87/#54. When reporting on comparative financial statements where the financial statements of the prior
Selected Questions

M87#55. When an auditor reports on financial statements prepared on an entity’s income tax basis, the auditor’s report should
   a. Disclose that the statements are not intended to conform with generally accepted accounting principles.
   b. Disclose that the statements were examined in accordance with generally accepted auditing standards.
   c. Express an opinion on whether the statements are presented in conformity with the comprehensive basis of accounting used.
   d. Include an explanation of how the results of operations differ from the cash receipts and disbursements basis of accounting.

M87#56. Management of Blue Company has decided not to account for a material transaction in accordance with the provisions of an FASB Standard. In setting forth its reasons in a note to the financial statements, management has clearly demonstrated that due to unusual circumstances the financial statements presented in accordance with the FASB Standard would be misleading. The auditor’s report should include an explanatory separate paragraph and contain a(an)
   a. Adverse opinion.
   b. Unqualified opinion.
   c. “Except for” qualified opinion.
   d. “Subject to” qualified opinion.

M87#57. Given one or more hypothetical assumptions, a responsible party may prepare, to the best of its knowledge and belief, an entity’s expected financial position, results of operations, and changes in financial position. Such prospective financial statements are known as
   a. Pro forma financial statements.
   b. Financial projections.
   c. Partial presentations.
   d. Financial forecasts.

M87#58. Which of the following are prospective financial statements upon which an accountant may appropriately report for general use?
   a. Pro forma financial statements.
   b. Financial projections.
   c. Partial presentations.
   d. Financial forecasts.

M87#60. If an 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. Unqualified opinion.
   b. Disclaimer of opinion.
   c. “Except for” qualified opinion.
   d. “Subject to” qualified opinion.

M87#64. The auditor should consider expressing a “subject to” qualified opinion when
   a. The auditor is prevented from completing a procedure required by generally accepted auditing standards.
   b. The financial statements fail to disclose information required by generally accepted accounting principles.
   c. The auditor decides to make reference to the report of another auditor.
   d. A question arises about the entity’s continued existence.

M87#48. When the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, the auditor should
   a. Qualify the opinion and explain the effect of the departure from generally accepted accounting principles in a separate paragraph.
   b. Qualify the opinion and describe the departure from generally accepted accounting principles within the opinion paragraph.
   c. Disclaim an opinion and explain the effect of the departure from generally accepted accounting principles in a separate paragraph.
   d. Disclaim an opinion and describe the departure from generally accepted accounting principles within the opinion paragraph.

M87#49. Which of the following should be included in an accountant’s standard report based upon the review of a nonpublic entity’s financial statements?
   a. A statement that the review was performed in accordance with generally accepted review standards.
   b. A statement that a review consists principally of inquiries and analytical procedures.
   c. A statement that the accountant is independent with respect to the entity.
   d. A statement that a review is substantially greater in scope than a compilation.
Auditing

N86#50. Which of the following should not be included in an accountant's standard report based upon the compilation of an entity's financial statements?
   a. A statement that a compilation is limited to presenting information that is the representation of management.
   b. A statement that the compilation was performed in accordance with standards established by the American Institute of CPAs.
   c. A statement that the accountant has not audited or reviewed the financial statements.
   d. A statement that the accountant does not express an opinion but expresses only limited assurance on the financial statements.

N86#51. Under which of the following circumstances would a disclaimer of opinion not be appropriate?
   a. The financial statements fail to contain adequate disclosure concerning related party transactions.
   b. The client refuses to permit its attorney to furnish information requested in a letter of audit inquiry.
   c. The auditor is engaged after fiscal year-end and is unable to observe physical inventories or apply alternative procedures to verify their balances.
   d. The auditor is unable to determine the amounts associated with illegal acts committed by the client's management.

N86#52. If an accountant concludes that unaudited financial statements on which the accountant is disclaiming an opinion also lack adequate disclosure, the accountant should suggest appropriate revision. If the client does not accept the accountant's suggestion, the accountant should
   a. Issue an adverse opinion and describe the appropriate revision in the report.
   b. Make reference to the appropriate revision and issue a modified report expressing limited assurance.
   c. Describe the appropriate revision to the financial statements in the accountant's disclaimer of opinion.
   d. Accept the client's inaction because the statements are unaudited and the accountant has disclaimed an opinion.

N86#53. When reporting on comparative financial statements where the financial statements of the prior year have been examined by a predecessor auditor whose report is not presented, the successor auditor should make
   a. No reference to the predecessor auditor.
   b. Reference to the predecessor auditor only if the predecessor auditor expressed a qualified opinion.
   c. Reference to the predecessor auditor only if the predecessor auditor expressed an unqualified opinion.
   d. Reference to the predecessor auditor regardless of the type of opinion expressed by the predecessor auditor.

N86#54. When reporting on comparative financial statements, which of the following circumstances ordinarily should cause the auditor to change the previously issued opinion on the prior year's financial statements?
   a. A change in accounting principle caused a consistency exception in the current year's auditor's report.
   b. The prior year opinion was unqualified and the current year opinion was qualified due to a scope limitation.
   c. A major uncertainty that caused a qualified opinion on the prior year's financial statements was resolved during the current year.
   d. The financial statements of the prior year are restated following a pooling of interests in the current year.

N86#56. In which of the following circumstances would an auditor be most likely to express an adverse opinion?
   a. The statements are not in conformity with the FASB Statements regarding the capitalization of leases.
   b. Information comes to the auditor's attention that raises substantial doubt about the entity's ability to continue in existence.
   c. The chief executive officer refuses the auditor access to minutes of board of directors' meetings.
   d. Compliance tests show that the entity's system of internal accounting control is so poor that it can not be relied upon.

N86#57. The objective of a review of interim financial information is to provide the accountant with a basis for reporting whether
   a. A reasonable basis exists for expressing an updated opinion regarding the financial statements that were previously audited.
   b. Material modifications should be made to conform with generally accepted accounting principles.
   c. The financial statements are presented fairly in accordance with standards of interim reporting.
   d. The financial statements are presented fairly in accordance with generally accepted accounting principles.
**Selected Questions**

**M86#58.** An auditor’s report would be designated as a special report when it is issued in connection with financial statements that are

a. For an interim period and are subjected to a limited review.
b. Unaudited and are prepared from a client’s accounting records.
c. Prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.
d. Purported to be in accordance with generally accepted accounting principles but do not include a presentation of the statement of changes in financial position.

**M86#3.** Edwards Corp. uses the last-in, first-out method of costing for half of its inventory and the first-in, first-out method of costing for the other half of its inventory. Because of these recording and reporting methods, the auditor should issue a(an)

a. Unqualified opinion.
b. Disclaimer of opinion.
c. "Except for” qualified opinion.
d. "Subject to” qualified opinion.

**M86#23.** 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. Attach a footnote explaining the effects of the departure.
b. Disclose the departure in a separate paragraph of the report.
c. Issue a compilation report.
d. Issue an adverse opinion.

**M86#35.** 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. Obtain written approval from the predecessor auditor to include the prior year’s financial statements.
b. Issue a standard comparative audit report indicating the division of responsibility.
c. Express an opinion on the current year statements alone and make no reference to the prior year statements.
d. Disclose the reasons for any qualification in the predecessor auditor’s opinion.

**M86#49.** The auditor who intends to express a qualified opinion should disclose all the substantive reasons in a separate explanatory paragraph of the report, except when the opinion paragraph

a. Makes reference to a contingent liability.
b. Describes a limitation on the scope of the examination.
c. Describes the use of an accounting principle at variance with generally accepted accounting principles.
d. Makes reference to a change in accounting principle.

**M86#50.** Which of the following requires recognition in the auditor’s opinion as to consistency?

a. The correction of an error in the prior year’s financial statements resulting from a mathematical mistake in capitalizing interest.
b. The change from the cost method to the equity method of accounting for investments in common stock.
c. A change in the estimate of provisions for warranty costs.
d. A change in depreciation method which has no effect on current year’s financial statements but is certain to affect future years.

**M86#51.** An auditor includes a separate paragraph in an otherwise unqualified report to emphasize that the entity being reported upon had significant transactions with related parties. The inclusion of this separate paragraph

a. Violates generally accepted auditing standards if this information is already disclosed in footnotes to the financial statements.
b. Necessitates a revision of the opinion paragraph to include the phrase “with the foregoing explanation.”
c. Is appropriate and would not negate the unqualified opinion.
d. Is considered an “except for” qualification of the report.

**M86#52.** When an independent CPA is associated with the financial statements of a publicly held entity but has not audited or reviewed such statements, the appropriate form of report to be issued must include a(an)

a. Disclaimer of opinion.
b. Compilation report.
c. Adverse opinion.
d. Unaudited association report.

**M86#55.** A limitation on the scope of the auditor’s examination sufficient to preclude an unqualified opinion will always result when management

a. Asks the auditor to report on the balance sheet and not on the other basic financial statements.
b. Refuses to permit its lawyer to respond to the letter of audit inquiry.
c. Discloses material related-party transactions in the footnotes to the financial statements.
d. Knows that confirmation of accounts receivable is not feasible.

**M86#56.** When an auditor conducts an examination in accordance with generally accepted auditing standards and concludes that the financial statements are
fairly presented in accordance with a comprehensive basis of accounting other than generally accepted accounting principles such as the cash basis of accounting, the auditor should issue a

a. Disclaimer of opinion.
b. Review report.
c. Qualified opinion.
d. Special report.

M86#57. When an independent accountant issues a comfort letter to an underwriter containing comments on data that have not been audited, the underwriter most likely will receive

a. A disclaimer on prospective financial statements.
b. A limited opinion on "pro forma" financial statements.
c. Positive assurance on supplementary disclosures.
d. Negative assurance on capsule information.

M86#59. When the financial statements are prepared on the going concern basis but the auditor concludes there is substantial doubt whether the client can continue in existence and also believes there are uncertainties about the recoverability of recorded asset amounts on the financial statements, the auditor may issue a:

a. Adverse opinion.
b. "Except for" qualified opinion.
c. "Subject to" qualified opinion.
d. Unqualified opinion with an explanatory separate paragraph.

M86#60. Which of the following is not usually performed by the accountant in a review engagement of a nonpublic entity?

a. Writing an engagement letter to establish an understanding of the services to be performed.
b. Issuing a report stating that the review was performed in accordance with standards established by the AICPA.
c. Communicating any material weaknesses discovered during the study and evaluation of internal accounting control.
d. Reading the financial statements to consider whether they conform with generally accepted accounting principles.

N85

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.

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.

N85#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:

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.

N85#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 can not be applied, although the in-
dependent 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.

N85#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.

N85#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.

N85#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.

N85#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.

N85#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 from an accounting 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.

N85#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.
Auditing

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.
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#36. When financial statements are presented that are not in conformity with generally accepted accounting principles an auditor may issue a(an)

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<tr>
<th>&quot;Except for&quot; opinion</th>
<th>Disclaimer of an opinion</th>
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<tr>
<td>a. Yes</td>
<td>No</td>
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<td>b. Yes</td>
<td>Yes</td>
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<tr>
<td>c. No</td>
<td>Yes</td>
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<td>d. No</td>
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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#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.

M84#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.

M84#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.
Selected Questions

N84#22. If the auditor obtains satisfaction with respect to the accounts receivable balance by alternative procedures because it is impracticable to confirm accounts 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.

c. Qualified opinion.
d. Disclaimer of opinion.

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#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#50. 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.

N84#54. An auditor's report on financial statements that are prepared in accordance with a comprehensive basis of accounting other than generally accepted ac-
counting 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.
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.

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.

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.

If the auditor believes there is minimal likelihood that resolution of an uncertainty will have a material effect on the financial statements, the auditor would issue a (an)
a. “Except for” opinion.
b. Adverse opinion.
c. Unqualified opinion.
d. “Subject to” opinion.

The predecessor auditor, who is satisfied after properly communicating with the successor auditor, has issued 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 successor auditor in the scope and opinion paragraphs.
c. Reference to both the work and the report of the successor auditor only in the opinion paragraph.
d. Reference to the report of the successor auditor only in the scope paragraph.

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.

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.

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.

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.

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.

An auditor’s standard report expressed an unqualified opinion and includes a middle paragraph that emphasizes a matter included in the notes to the
Selected Questions

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#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(an)

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#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#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#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(an)

a. Unqualified opinion with appropriate reference to the middle paragraph.

b. Example of inappropriate reporting.

c. Adverse opinion.

d. Negative assurance opinion.

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#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#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 an
   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.”

B. Other Reporting Considerations

M87#49. When an independent accountant’s report based on a review of interim financial information is incorporated by reference in a registration statement, the Securities and Exchange Commission requires that the prospectus clarify that the accountant’s report is not
   a. A part of the registration statement within the meaning of the Securities Act of 1933.
   b. Subject to the Statements on Standards for Accounting and Review Services.
   c. To be relied upon due to the limited nature of the procedures applied.
   d. Included in the company’s quarterly report on Form 10-Q.

M87#52. The principal auditor is satisfied with the independence and professional reputation of the other
Selected Questions

M87#56. Subsequent to the issuance of the auditor’s report, the auditor became aware of facts existing at the report date that would have affected the report had the auditor then been aware of such facts. After determining that the information is reliable, the auditor should next
   a. Notify the board of directors that the auditor’s report must no longer be associated with the financial statements.
   b. Determine whether there are persons relying or likely to rely on the financial statements who would attach importance to the information.
   c. Request that management disclose the effects of the newly discovered information by adding a footnote to subsequently issued financial statements.
   d. Issue revised pro forma financial statements taking into consideration the newly discovered information.

M87#59. Which of the following best describes the auditor’s reporting responsibility concerning information accompanying the basic financial statements in an auditor-submitted document?
   a. The auditor should report on all the information included in the document.
   b. The auditor should report on the basic financial statements but may not issue a report covering the accompanying information.
   c. The auditor should report on the information accompanying the basic financial statements only if the auditor participated in the preparation of the accompanying information.
   d. The auditor should report on the information accompanying the basic financial statements only if the document is being distributed to public shareholders.

M86#55. When an auditor reissues in 1986 the auditor’s report on the 1983 financial statements at the request of the client without revising the 1983 wording, the auditor should
   a. Use the date of the original report.
   b. Use the date of the client’s request.
   c. Use the date of the current period report.
   d. Dual date the report.

M86#59. If a publicly held entity declines to include in its financial report supplementary information required by the FASB, the auditor should issue
   a. An unqualified opinion with a separate explanatory paragraph.
   b. Either a disclaimer of opinion or an adverse opinion.
   c. Either an “except for” qualified opinion or a disclaimer of opinion.
   d. Either an adverse opinion or an “except for” qualified opinion.

M86#60. Comfort letters are ordinarily signed by the
   a. Client.
   b. Client’s lawyer.
   c. Independent auditor.
   d. Internal auditor.

M86#68. 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 that report unless
   a. A final resolution of a contingency that had resulted in a qualification of the auditor’s report is made.
   b. A development occurs that may affect the client’s ability to continue as a going concern.
   c. An investigation of the auditor’s practice by a peer review committee ensues.
   d. New information is discovered concerning undisclosed related party transactions of the previously audited period.

M86#11. 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. Both the scope and opinion paragraphs of the report.
   b. Only the scope paragraph of the report.
   c. Only the opinion paragraph of the report.
   d. Only the opinion paragraph of the report and include an explanatory middle paragraph.

M86#15. The auditor concludes that there is a material inconsistency in the other information in an annual report to shareholders containing audited financial statements. If the client refuses to revise or eliminate the material inconsistency, the auditor should
   a. Revise the auditor’s report to include a separate explanatory paragraph describing the material inconsistency.
   b. Consult with a party whose advice might influence the client, such as the client’s legal counsel.
   c. Issue a qualified opinion after discussing the matter with the client’s board of directors.
   d. Consider the matter closed since the other information is not in the audited financial statements.
N85#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.

M85#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.

M85#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.

M85#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#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#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.

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**Selected Questions**

**N84#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.

**N84#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.

**N83#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.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

A. General Standards and Rules of Conduct

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B. Control of the Audit

C. Other Responsibilities

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II. Internal Control

A. Definitions and Basic Concepts

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B. Study and Evaluation of the System

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| M87#45 a | N86#41 b | N86#44 a |
| M87#46 c | M86#9 c | M86#10 a |
| M87#47 a | M86#11 a | M86#12 a |
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| M87#49 b | M86#15 a | M86#16 b |
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A. Reporting Standards and Types of Reports

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IV. Reporting

A. Reporting Standards and Types of Reports

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| M85#36 a | N83#54 d |
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| A-59 |
ESSAYS — SELECTED QUESTIONS

I. Professional Responsibilities

M87
Number 5 (Estimated time — 15 to 25 minutes)

Parker is the in-charge auditor with administrative responsibilities for the upcoming annual audit of FGH Company, a continuing audit client. Parker will supervise two assistants on the engagement and will visit the client before the field work begins.

Parker has started the planning process by preparing a list of procedures to be performed prior to the beginning of field work. The list includes:

1. Review correspondence and permanent files.
2. Review prior years' audit working papers, financial statements, and auditor's reports.
3. Discuss with CPA firm personnel responsible for audit and non-audit services to the client, matters that may affect the examination.
4. Discuss with management current business developments affecting the client.

Required:
Complete Parker's list of procedures to be performed prior to the beginning of field work.

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

N86
Number 3 (Estimated time — 15 to 25 minutes)

The overall purpose of the auditor's review of the internal accounting control system is to obtain sufficient knowledge and understanding about the accounting system and the internal accounting control system to: (a) make a determination of whether there are internal accounting control procedures that may provide a basis for reliance thereon in determining the nature, extent, and timing of substantive tests; or (b) aid the auditor in designing substantive tests in the absence of such reliance.

Required:

a. 1. What knowledge should the auditor obtain from the preliminary phase of the review of the internal accounting control system?
   2. How does the auditor obtain this knowledge?

b. Upon completion of the preliminary phase, what possible conclusions may the auditor reach and how would each affect the auditor's substantive tests?

c. What is the appropriate extent of the auditor's documentation of the review of internal accounting control? Do not describe documentation of compliance testing.
B. Study and Evaluation of the System

Number 4 (Estimated time — 15 to 25 minutes)

Ajax Inc., an audit client, recently installed a new EDP system to process more efficiently the shipping, billing, and accounts receivable records. During interim work, an assistant completed the review of the accounting system and the internal accounting controls. The assistant determined the following information concerning the new EDP system and the processing and control of shipping notices and customer invoices.

Each major computerized function, i.e., shipping, billing, accounts receivable, etc., is permanently assigned to a specific computer operator who is responsible for making program changes, running the program, and reconciling the computer log. Responsibility for the custody and control over the magnetic tapes and system documentation is randomly rotated among the computer operators on a monthly basis to prevent any one person from having access to the tapes and documentation at all times. Each computer programmer and computer operator has access to the computer room via a magnetic card and a digital code that is different for each card. The systems analyst and the supervisor of the computer operators do not have access to the computer room.

The EDP system documentation consists of the following items: program listing, error listing, logs, and record layout. To increase efficiency, batch totals and processing controls are omitted from the system.

Ajax ships its products directly from two warehouses which forward shipping notices to general accounting. There, the billing clerk enters the price of the item and accounts for the numerical sequence of the shipping notices. The billing clerk also prepares daily adding machine tapes of the units shipped and the sales amounts. Shipping notices and adding machine tapes are forwarded to the computer department for processing. The computer output consists of:

- A three-copy invoice that is forwarded to the billing clerk, and
- A daily sales register showing the aggregate totals of units shipped and sales amounts that the computer operator compares to the adding machine tapes.

The billing clerk mails two copies of each invoice to the customer and retains the third copy in an open invoice file that serves as a detail accounts receivable record.

Required:

Describe one specific recommendation for correcting each weakness in internal accounting controls in the new EDP system and for correcting each weakness or inefficiency in the procedures for processing and controlling shipping notices and customer invoices.

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.
**Selected Questions**

**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.
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.
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?

C. Cycles

Harris, CPA, has been engaged to audit the financial statements of the Spartan Drug Store, Inc. Spartan is a medium sized retail outlet that sells a wide variety of consumer goods. All sales are for cash or check. Cashiers utilize cash registers to process these transactions. There are no receipts by mail and there are no credit card or charge sales.

Required:
Construct the “Processing Cash Collections” segment of the internal accounting control questionnaire on “Cash Receipts” to be used in the evaluation of the system of internal accounting control for the Spartan Drug Store, Inc. Each question should elicit either a yes or no response. Do not discuss the internal accounting controls over cash sales.
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

<table>
<thead>
<tr>
<th>TO</th>
<th>SHIP TO</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**DATE TO BE SHIPPED**

<table>
<thead>
<tr>
<th>SHIP VIA</th>
<th>DISC. TERMS</th>
<th>FREIGHT TERMS</th>
<th>ADV. ALLOWANCE</th>
<th>SPECIAL ALLOWANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**QUANTITY**

<table>
<thead>
<tr>
<th>DESCRIPTION</th>
</tr>
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<tbody>
<tr>
<td></td>
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<td></td>
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<tr>
<td></td>
</tr>
</tbody>
</table>

**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?
Required:
Indicate what each of the letters (A) through (L) represents. Do not discuss adequacies or inadequacies in the system of internal control.
D. Other Considerations

M87
Number 4 (Estimated time — 15 to 25 minutes)

Martin, CPA, has been engaged to express an opinion on Beta Manufacturing Company's system of internal accounting control in effect as of June 1, 1987.

Required:

a. Compare Martin's examination of the system of internal accounting control for the purpose of expressing an opinion on it with the study and evaluation of internal accounting control made as part of an examination of the financial statements in accordance with generally accepted auditing standards. The comparison should be made as to the 1) scope, 2) purpose, and 3) timing of the engagements, and 4) users of the reports.

b. Identify the major contents of Martin's report expressing an opinion on Beta's system of internal accounting control. Do not draft the report.

III. Evidence and Procedures

A. Audit Evidence

N86
Number 2 (Estimated time — 15 to 25 minutes)

Audit risk and materiality should be considered when planning and performing an examination of financial statements in accordance with generally accepted auditing standards. Audit risk and materiality should also be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

Required:

a. 1. Define audit risk.
   2. Describe its components of inherent risk, control risk, and detection risk.
   3. Explain how these components are interrelated.

b. 1. Define materiality.
   2. Discuss the factors affecting its determination.
   3. Describe the relationship between materiality for planning purposes and materiality for evaluation purposes.

N85
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 statement.
   • 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.
Selected Questions

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.

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 Wholesaling 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 Luddy, the auditor, reviewed matters that were supposed to be included in a written representation letter. Upon receipt of the following client representation letter, Luddy contacted Alderman to state that it was incomplete.

To E. K. Luddy, 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

<table>
<thead>
<tr>
<th>Balance per bank (a)</th>
<th>$18,375.91</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits in Transit (b)</td>
<td></td>
</tr>
<tr>
<td>12/30</td>
<td>$1,471.10</td>
</tr>
<tr>
<td>12/31</td>
<td>2,840.69</td>
</tr>
<tr>
<td>Subtotal</td>
<td>4,311.79</td>
</tr>
<tr>
<td>Outstanding checks (c)</td>
<td>22,687.70</td>
</tr>
<tr>
<td>837</td>
<td>6,000.00</td>
</tr>
<tr>
<td>1941</td>
<td>671.80</td>
</tr>
<tr>
<td>1966</td>
<td>320.00</td>
</tr>
<tr>
<td>1984</td>
<td>1,855.42</td>
</tr>
<tr>
<td>1985</td>
<td>3,621.22</td>
</tr>
<tr>
<td>1987</td>
<td>2,576.89</td>
</tr>
<tr>
<td>1991</td>
<td>4,420.88</td>
</tr>
<tr>
<td>Subtotal</td>
<td>(19,466.21)</td>
</tr>
<tr>
<td>NSF check returned</td>
<td>3,221.49</td>
</tr>
<tr>
<td>12/29 (d)</td>
<td>200.00</td>
</tr>
<tr>
<td>Bank charges</td>
<td>5.50</td>
</tr>
<tr>
<td>Error Check No. 1932</td>
<td>148.10</td>
</tr>
<tr>
<td>Customer note collected by the bank ($2,750 plus $275 interest) (e)</td>
<td>(3,025.00)</td>
</tr>
<tr>
<td>Balance per books (f)</td>
<td>$ 550.09</td>
</tr>
</tbody>
</table>

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.

B. Specific Audit Objectives and Procedures

M86
Number 2 (Estimated time — 15 to 25 minutes)

Jones, CPA, the continuing auditor of Sussex, Inc., is beginning the audit of the common stock and treasury stock accounts. Jones has decided to design substantive tests without reliance on internal accounting control.

Sussex has no par, no stated value common stock and acts as its own registrar and transfer agent. During the past year Sussex both issued and reacquired shares of its own common stock, some of which the company still owned at year-end. Additional common stock transactions occurred among the shareholders during the year.

Common stock transactions can be traced to individual shareholders' accounts in a subsidiary ledger and to a stock certificate book. The company has not paid any cash or stock dividends. There are no other classes of stock, stock rights, warrants, or option plans.

Required:
What substantive audit procedures should Jones apply in examining the common stock and treasury stock accounts?

M85
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.
Selected Questions

M84
Number 2 (Estimated time — — 15 to 25 minutes)

Pierce, an independent auditor, was engaged to examine the financial statements of Mayfair Construction 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 to 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

Gross apartment rents (Schedule A) $1,600,800*
Less vacancies (Schedule B) 20,500*
Net apartment rentals 1,580,300
Less unpaid January rents (Schedule C) 7,800*
Total 1,572,500
Add prepaid rent collected (Apartment 116) 500*
Total cash collected $1,573,000*

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 (*)?

C. Other Specific Audit Topics

M87
Number 3 (Estimated time — — 15 to 25 minutes)

Edwards has decided to use Probability Proportional to Size (PPS) sampling, sometimes called dollar-unit sampling, in the audit of a client’s accounts receivable balance. Few, if any, errors of account balance overstatement are expected.

Edwards plans to use the following PPS sampling table:

| TABLE |
| Reliability Factors for Errors of Overstatement |
| Number of Overstatement Errors | Risk of Incorrect Acceptance |
| 0 | 1% | 5% | 10% | 15% | 20% |
| 1 | 4.61 | 3.00 | 2.31 | 1.90 | 1.61 |
| 2 | 6.64 | 4.75 | 3.89 | 3.38 | 3.00 |
| 3 | 8.41 | 6.30 | 5.33 | 4.72 | 4.28 |
| 4 | 10.05 | 7.76 | 6.69 | 6.02 | 5.52 |
| 5 | 11.61 | 9.16 | 8.00 | 7.27 | 6.73 |

Required:
a. Identify the advantages of using PPS sampling over classical variables sampling.

Note: Requirements b and c are not related.
b. Calculate the sampling interval and the sample size Edwards should use given the following information:

Tolerable error ................................................ $15,000
Risk of incorrect acceptance ................................. 5%
Number of errors allowed .................................. 0
Recorded amount of accounts receivable ….. $300,000

Note: Requirements b and c are not related.
c. Calculate the total projected error if the following three errors were discovered in a PPS sample:

<table>
<thead>
<tr>
<th>Recorded Amount</th>
<th>Audit Amount</th>
<th>Sampling Interval</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st error $400</td>
<td>$320</td>
<td>$1,000</td>
</tr>
<tr>
<td>2nd error 500</td>
<td>0</td>
<td>1,000</td>
</tr>
<tr>
<td>3rd error 3,000</td>
<td>2,500</td>
<td>1,000</td>
</tr>
</tbody>
</table>

M86
Number 5 (Estimated time — — 15 to 25 minutes)

Smith, CPA, has decided to rely on an audit client’s internal accounting controls affecting receivables. Smith plans to use sampling to obtain substantive evi-
Auditing

dence concerning the reasonableness of the client’s accounts receivable balances. Smith has identified the first few steps in an outline of the sampling plan as follows:

1. Determine the audit objectives of the test.
2. Define the population.
3. Define the sampling unit.
4. Consider the completeness of the population.
5. Identify individually significant items.

Required:
Identify the remaining steps which Smith should include in the outline of the sampling plan. Illustrations and examples need not be provided.

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

M87
Number 2 (Estimated time — 15 to 25 minutes)

The following report was drafted by a staff assistant at the completion of the calendar year 1986 review engagement of RLG Company, a continuing client. The 1985 financial statements were compiled. On March 6, 1987, the date of the completion of the review, the report was submitted to the partner with client responsibility. The financial statements for 1985 and 1986 are presented in comparative form.

To the Board of Directors of RLG Company

We have reviewed the accompanying financial statements of RLG Company for the year ended December 31, 1986, in accordance with standards established by Statements on Standards for Auditing and Review Services.

A review consists principally of analytical procedures applied to financial data. It is substantially more in scope than a compilation, but 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.

Based on our compilation and review, we are not aware of any material modifications that should be made to the 1985 and 1986 financial statements in order for them to be consistent with the prior year’s financial statements.

The accompanying 1985 financial statements of RLG Company were compiled by us and, accordingly, we do not express an opinion on them.

March 6, 1987

Required:
Identify the deficiencies in the draft of the proposed report. Group the deficiencies by paragraph. Do not redraft the report.

N86
Number 5 (Estimated time — 15 to 25 minutes)

On September 30, 1985, White & Co., CPAs, was engaged to audit the consolidated financial statements of National Motors, Inc. for the year ended December 31, 1985. The consolidated financial statements of National had not been audited the prior year. National’s inadequate inventory records precluded White from forming an opinion as to the proper or consistent application of generally accepted accounting principles to inventory balances on January 1, 1985. Therefore, White decided not to express an opinion on the results of operations for the year ended December 31, 1985. National elected not to present comparative financial statements.

Rapid Parts Company, a consolidated subsidiary of National, was audited for the year ended December 31, 1985, by Green & Co., CPAs. Green completed its field work on February 28, 1986, and submitted an unqualified opinion on Rapid’s financial statements on March 7, 1986. Rapid’s statements reflect total assets and revenues constituting 22% and 25%, respectively, of the consolidated totals of National. White decided not to assume responsibility for the work of Green.

Green’s report on Rapid does not accompany National’s consolidated statements.

Selected Questions

Required:
Prepare White and Company's auditor's report on the consolidated financial statements of National Motors, Inc.

M86
Number 3 (Estimated time — — 15 to 25 minutes)

Brown & Brown, CPAs, was engaged by the board of directors of Cook Industries, Inc. to audit Cook's calendar year 1985 financial statements. The following report was drafted by an audit assistant at the completion of the engagement. It was submitted to Brown, the partner with client responsibility for review on March 7, 1986, the date of the completion of fieldwork. Brown has reviewed matters thoroughly and properly concluded that an adverse opinion was appropriate.

Brown also became aware of a March 14, 1986 subsequent event which the client has properly disclosed in the notes to the financial statements. Brown wants responsibility for subsequent events to be limited to the specific event referred to in the applicable note to the client's financial statements.

The financial statements of Cook Industries, Inc., for the calendar year 1984 were examined by predecessor auditors who also expressed an adverse opinion and have not reissued their report. The financial statements for 1984 and 1985 are presented in comparative form.

Report of Independent Accountants

To the President of Cook Industries, Inc.

We have examined the financial statements of Cook Industries, Inc., for the year ended December 31, 1985. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records as we considered necessary in the circumstances. As discussed in Note K to the financial statements, the Company has properly disclosed a subsequent event dated March 14, 1986.

As discussed in Note G to the financial statements, the Company carries its property and equipment at appraisal values, and provides depreciation on the basis of such values. Further, the company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales.

In our opinion, the financial statements referred to above do not present fairly the financial position of Cook Industries, Inc. as of December 31, 1985, or the results of its operations and changes in its financial position for the year then ended, applied on a basis consistent with that of the preceding year.

Brown & Brown, CPAs

March 7, 1986

Required:
Identify the deficiencies in the draft of the proposed report. Do not redraft the report or discuss corrections.

N85
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.

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.
Auditing

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.

N84 Number 5 (Estimated time — 15 to 25 minutes)

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.

N84 Number 2 (Estimated time — 15 to 25 minutes)

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.

N83 Number 3 (Estimated time — 15 to 25 minutes)

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 auditors, 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.
Selected Questions

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.

M83
Number 3 (Estimated time — — 15 to 25 minutes)

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.

Pate & Co., CPAs

December 31, 1982

Required:

Identify all of the deficiencies in the above draft of the proposed report.

B. Other Reporting Considerations

N85
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.

A-77
SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

**M87**
**Answer 5 (10 points)**

Additional procedures to be performed prior to the beginning of field work are:

5. Read the current year's interim financial statements.
6. Discuss the scope of the examination with management of the client.
7. Establish the timing of the audit work.
8. Arrange with the client for adequate working space.
9. Coordinate the assistance of client personnel in data preparation.
10. Establish and coordinate staffing requirements including time budget.
11. Hold a planning conference with assistants assigned to the engagement.
12. Determine the extent of involvement, if any, of consultants, specialists, and internal auditors.
13. Consider the effects of applicable accounting and auditing pronouncements, particularly recent ones.
14. Consider the need for an appropriate engagement letter.
15. Prepare documentation setting forth the preliminary audit plan.
16. Make preliminary judgment about materiality levels.
17. Make preliminary judgment about reliance to be placed on internal accounting controls.
18. Update the prior year's written audit program.

**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.
Auditing

II. Internal Control

A. Definitions and Basic Concepts

N86 Answer 3 (10 points)

a. 1. The auditor should obtain an understanding of the control environment and an understanding of the flow of transactions through the accounting system.
   2. The auditor’s knowledge ordinarily is obtained by a combination of previous experience with the entity, inquiry, observation, reference to prior year working papers, and client prepared descriptions of the system.

b. Upon completion of the preliminary phase of the review, the auditor may conclude:

- Further study and evaluation are unlikely to justify any restriction of substantive tests. Therefore, the auditor should discontinue further study and evaluation and should design substantive tests that do not rely on internal accounting control.

          or

- Audit effort required to study and evaluate the design of the system and to test compliance with prescribed control procedures to justify reliance to restrict the extent of substantive tests exceeds the reduction in audit effort that could be achieved by such reliance. Therefore, the auditor should discontinue further study and evaluation and should design substantive tests that do not rely on internal accounting control.

          or

- Reliance on the system is warranted. Therefore, the auditor should complete the review of the system to determine whether the internal accounting control procedures are suitably designed to provide reasonable assurance that they will prevent or detect errors or irregularities.

c. If after the preliminary phase of the review the auditor does not plan to rely on the controls in the system to restrict substantive tests, documentation may be limited to a record of the auditor’s reasons for deciding not to extend the review. The auditor’s understanding of the internal accounting control system need not be documented if no reliance is placed on it.

   If the auditor does plan to rely on the controls in the system, the extent of documentation of the review depends on the anticipated reliance on internal accounting control, the nature of the entity’s system, and the entity’s documentation of the system. Documentation should include the auditor’s understanding of the system and the basis for the conclusion that the internal accounting control procedures on which the auditor intends to rely are suitably designed to provide reasonable assurance that errors or irregularities will be prevented or detected. The form of the documentation may be questionnaires, narrative memorandums, flowcharts, decision tables, or any other appropriate form.

B. Study and Evaluation of the System

N86 Answer 4 (10 points)

Recommendations for correcting weaknesses in the internal accounting controls in the new EDP system and weaknesses and inefficiencies in the procedures for processing and controlling shipping notices and customer invoices:

- The functions of programming, machine operations, and control should be assigned to different employees.

- Computer log should be reconciled by the computer operations supervisor or other independent employee.

- Access to tapes and documentation should be controlled by an independent employee or through the use of restricted authorization code.

- Programmers’ access to computers should be limited to testing and debugging.

- The supervisor of the computer operators should have access to the computer room.

- The EDP system’s documentation should also include flowcharts, computer programs, and operator instructions.

- Batch totals (control totals, hash totals, record counts) should be utilized to assure that data have been properly authorized and not lost or otherwise improperly changed.

- Processing controls should be put in place to assure that errors in the input records will be detected when processing occurs. Among the possible processing controls are completeness tests, validation tests, sequence tests, and limit or reasonableness tests.

- The price list should be placed on a master file in the computer and matched with product numbers on the shipping notices to obtain appropriate prices.

- The computer should be programmed to review the numerical sequence of shipping notices and list missing numbers.

- The billing clerk or other designated control clerk should retain the adding machine tapes or a copy of them to compare the total with the daily sales register.
• Copies of invoices should be forwarded by the computer department to the mailroom clerk for mailing to the customers.

• An individual who is independent of billing and cash collections should maintain the accounts receivable records; or if the records are updated by the computer department, there should be an independent review by general accounting.

• The accounts receivable records maintained manually in an open file should be more efficiently maintained on magnetic tape.

**N85**

**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.

**M85**

**Answer 3** (10 points)

The weaknesses in Smallco Lumber's internal accounting controls are these:

**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 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.

**N84**

**Answer 3** (10 points)

The auditor's internal control questionnaire should include the following additional questions:

• Does access to the bank safe deposit vault require the signature or presence of two designated persons?

• Are all individuals who have access to marketable securities bonded?
Auditing

- Are those who have access to the securities denied access to the accounting records?
- Does the accounting department keep detailed records of —
  - 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?

C. Cycles

M86
Answer 4 (10 points)

*SPARTAN DRUG STORE, INC.*
Processing Cash Collections
Internal Accounting Control Questionnaire

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is a summary listing of cash register readings prepared by an employee who is independent of physically handling cash receipts?</td>
<td>( \text{Yes} )</td>
<td>( \text{No} )</td>
</tr>
<tr>
<td>Are receipts forwarded to an independent employee who makes the bank deposits?</td>
<td>( \text{No} )</td>
<td>( \text{Yes} )</td>
</tr>
<tr>
<td>Are each day’s receipts deposited intact daily?</td>
<td>( \text{No} )</td>
<td>( \text{Yes} )</td>
</tr>
<tr>
<td>Is the summary listing of cash register receipts reconciled to the duplicate deposit slips authenticated by the bank?</td>
<td>( \text{No} )</td>
<td>( \text{Yes} )</td>
</tr>
<tr>
<td>Are entries to the cash receipts journal prepared from duplicate deposit slips or the summary listing of cash register readings?</td>
<td>( \text{No} )</td>
<td>( \text{Yes} )</td>
</tr>
<tr>
<td>Are the entries to the cash receipts journal compared to the deposits per bank statement?</td>
<td>( \text{No} )</td>
<td>( \text{Yes} )</td>
</tr>
<tr>
<td>Are areas involving the physical handling of cash reasonably safeguarded?</td>
<td>( \text{No} )</td>
<td>( \text{Yes} )</td>
</tr>
<tr>
<td>Are employees who handle receipts bonded?</td>
<td>( \text{No} )</td>
<td>( \text{Yes} )</td>
</tr>
<tr>
<td>Are charged back items (NSF checks, etc.) directed to an employee who does not physically handle receipts or have access to the books?</td>
<td>( \text{No} )</td>
<td>( \text{Yes} )</td>
</tr>
</tbody>
</table>

N84
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
Unofficial Answers

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.
- 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.

M83
Answer 2 (10 points)

a. Purchase orders may vary in format and style. However, all purchase orders should include areas for insertion of the following information, which was not included in the illustration:

- Price
- Purchase order number
- Purchase order execution date
- Authorization signature

b. In the stores department purchase orders serve to

- Verify that the purchase order was executed as authorized.
- Verify that the quantities reported as received in the receiving department are correct.

In the purchasing department purchase orders serve as

- A control copy of outstanding orders until the order is received.
- A control copy that accounts for the numerical sequence of all purchase orders (to detect unauthorized use).

In the receiving department purchase orders serve to

- Authorize acceptance of specified merchandise.
- Establish an independent verification of quantities received (usually by compelling a blind count).

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
D. Other Considerations

**M87**

**Answer 4 (10 points)**

a. 1. An engagement to express an opinion on an entity's system of internal accounting control and a study and evaluation of internal accounting control made as part of an examination of financial statements in accordance with generally accepted auditing standards generally differ in scope. While the engagement to express an opinion on an entity's system can be made in conjunction with the study and evaluation made as part of an examination, the study and evaluation made as part of an examination is more limited in scope.

2. The engagements also differ in purpose. The auditor's study and evaluation of internal accounting control is an intermediate step in forming an opinion on the financial statements. It establishes a basis for reliance on the control system and for determining the nature, extent, and timing of the auditing procedures. The purpose of the accountant's engagement to express an opinion on the system of internal accounting control is to provide assurance about whether the broad objectives of internal accounting control are being achieved.

3. An engagement to express an opinion on an entity's system of internal accounting control can be made as of any date, while the auditor's study and evaluation of internal accounting control is made in the early stages of an audit with review to determine the effectiveness throughout the period.

4. Ordinarily, the users of an opinion on an entity's system of internal accounting control are the client's management or third parties, such as regulatory agencies. The primary user of a study and evaluation of internal accounting control made as part of an audit is the auditor who makes the study and evaluation.

b. The accountant's report expressing an opinion on an entity's system of internal accounting control should contain

a. A description of the scope of the engagement.

b. The date to which the opinion relates.

c. A statement that the establishment and maintenance of the system is the responsibility of management.

d. A brief explanation of the broad objectives and inherent limitations of internal accounting control.

e. The accountant's opinion on whether the system meets the broad objectives of internal accounting control insofar as those objectives pertain to the prevention or detection of material errors or irregularities.

f. The description of any material weakness.

III. Evidence and Procedures

A. Audit Evidence

**N86**

**Answer 2 (10 points)**

a. 1. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the auditor's opinion on financial statements that are materially misstated.

2. Inherent risk is the susceptibility of an account balance or class of transactions to error that could be material, when aggregated with error in other balances or classes, assuming that there were no related internal accounting controls.

Control risk is the risk that error that could occur in an account balance or class of transactions and that could be material, when aggregated with error in other balances or classes, will not be prevented or detected on a timely basis by the system of internal accounting control.

Detection risk is the risk that an auditor's procedures will lead the auditor to conclude that error in an account balance or class of transactions that could be material, when aggregated with error in other balances or classes, does not exist when in fact such error does exist.

3. Inherent risk and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor's procedures and can be changed at the auditor's discretion. Detection risk should bear an inverse relationship to inherent and control risk. The less the inherent and control risk the auditor believes exists, the greater the acceptable detection risk. Conversely, the greater the inherent and control risk the auditor believes exists, the less the acceptable detection risk.

b. 1. Materiality is the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. This concept recognizes that some matters, either individually or in the aggregate, are important for the fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important.

2. Materiality is affected by the nature and amount of an item in relation to the nature and amount of items in the financial statements under examination,
and the auditor's judgment as influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.

3. The auditor's judgment about materiality for planning purposes is ordinarily different from materiality for evaluation purposes because the auditor, when planning an audit, cannot anticipate all of the circumstances that may ultimately influence judgment about materiality in evaluating the audit findings at the completion of the audit. If significantly lower materiality levels become appropriate in evaluating the audit findings, the auditor should reevaluate the sufficiency of the audit procedures already performed.

N85

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 nonresonses 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 balance 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.

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 and client personnel concerning developments affecting the entity that require recognition in the audit plan.
- Documentation of a pre audit 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.
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.

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) investee.
- 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.

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.
- There are related party transactions or related amounts receivable or payable that have not been properly disclosed in the financial statements.
- 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.
- Events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.
- The accountant 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.
Unofficial Answers

- 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 requirements or at prices in excess of the prevailing market prices.

MB83  
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 outstanding 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.

B. Specific Audit Objectives and Procedures

MB86

Answer 2 (10 points)
The substantive audit procedures that Jones should apply in examining the common stock and treasury stock accounts are as follows:

- Review the corporate charter to verify details of the common stock such as authorized shares, par value, etc.
- Obtain or prepare an analysis of changes in common stock and treasury stock accounts.
- Compare opening balances with prior year's working papers.
- Foot the total shares outstanding in the stockholders' ledger and stock certificate book.
- Determine authorization for common stock issuances and treasury stock transactions by inspecting the minutes of the Board of Directors' meetings.
- Verify capital stock issuances by examining supporting documentation and tracing entries into the records.
- Verify treasury stock transactions by examining supporting documentation and tracing entries into the records.
- Examine all certificates canceled during the year.
- Inspect all treasury stock certificates owned by the client.
- Reconcile the details of the individual certificates in the stock certificate book with the individual shareholders' accounts in the stockholders' ledger.
- Compare the totals in the stockholders' ledger and the stock certificate book to the balance sheet presentation.
- Recompute the weighted average number of shares outstanding.
- Compare the financial statement presentation and disclosure with generally accepted accounting principles.
Auditing

- Determine the existence of and proper accounting for common stock and treasury stock transactions occurring since year-end.
- Obtain written representations concerning common and treasury stock in the client representation letter.

N85
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 & Dee to discuss Dey & Dee's audit procedures or a review of Dey & Dee's audit programs and/or working papers. In addition, May & 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.

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.
- Inspect documents in support of retirements during the year.
- Analyze repairs and maintenance for possible reclassifications.
- 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.
C. Other Specific Audit Topics

M87
Answer 3 (10 points)

a. The advantages of PPS sampling over classical variables sampling are as follows:

- PPS sampling is generally easier to use than classical variables sampling.
- Size of a PPS sample is not based on the estimated variation of audited amounts.
- PPS sampling automatically results in a stratified sample.
- Individually significant items are automatically identified.
- If no errors are expected, PPS sampling will usually result in a smaller sample size than classical variables sampling.
- A PPS sample can be easily designed and sample selection can begin before the complete population is available.

b. Sampling Interval = Tolerable Error
                           Reliability Factor for Errors of Overstatement
                           $15,000
                           3.00
                           $5,000

Sample Size = Recorded Amount
              Sampling Interval
              $300,000
              $5,000
              60

c. Recorded Amount | Audit Amount | Tainting | Sampling Interval | Projected Error
1st error $400       $320       20%        $1,000       $200
2nd error  500       0          100%       1,000        1,000
3rd error  3,000     2,500      *          1,000        500

Total Projected Error $1,700

* The recorded amount is greater than the sampling interval; therefore, the projected error equals the actual error.

M86
Answer 5 (10 points)

The remaining steps are as follows:

6. Treat the individually significant items as a separate population.

7. Choose an audit sampling technique.

8. Determine the sample size, giving consideration for —

   a. Variations within the population.
   b. Acceptable level of risk.
   c. Tolerable error.
   d. Expected amount of error.
   e. Population size.
Unofficial Answers

9. Determine the method of selecting a representative sample.

10. Select the sample items.

11. Apply appropriate audit procedures to the sample items.

12. Evaluate the sample results.
   a. Project the error to the population and consider sampling risk.
   b. Consider the qualitative aspects of errors and reach an overall conclusion.


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.
Auditing

IV. Reporting

A. Reporting Standards and Types of Reports

M87

Answer 2 (10 points)

Deficiencies in the staff assistant’s draft are as follows:

Within the first paragraph
- The financial statements are not identified by proper names.
- There should be reference to standards established by the AICPA, not Statements on Standards for Auditing and Review Services.
- There is failure to state that the financial statements are the representations of management.

Within the second paragraph
- There is omission of reference to inquiries of company personnel.
- It is inappropriate to state that a review is more in scope than a compilation.
- There is failure to disclaim an opinion.

Within the third paragraph
- Reference should not be made to compilation of the 1985 financial statements.
- The reference to “material modifications” should apply to the 1986 financial statements only, and not to the 1985 financial statements.
- Reference to consistency with the prior year’s financial statements should be omitted.
- There is failure to refer to conformity with generally accepted accounting principles.

Within the fourth paragraph
- There is failure to state that a compilation is limited to presenting in the form of financial statements information that is the representation of management.
- There is failure to state that the 1985 financial statements were not audited or reviewed.
- There is omission of proper reference to “any other form of assurance” on the 1985 financial statements.

M86

Answer 5 (10 points)

To the Board of Directors of National Motors, Inc.:

We have examined the consolidated balance sheet of National Motors, Inc. and subsidiaries as of December 31, 1985, and the related consolidated 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, except as indicated in the following paragraph. We did not examine the financial statements of Rapid Parts Company, a consolidated subsidiary, which statements reflect total assets and revenues constituting 22 percent and 25 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 herein, insofar as it relates to Rapid Parts Company, is based solely upon the report of the other auditors.

Because we were not engaged as auditors until after December 31, 1984, we were not present to observe the physical inventory taken at that date and because of inadequate records we were unable to satisfy ourselves by means of other procedures concerning inventory quantities. The amount of the inventory at December 31, 1984, enters materially into the determination of the results of operations and changes in financial position for the year ended December 31, 1985. Therefore, we do not express an opinion on the accompanying consolidated statements of income and retained earnings and changes in financial position for the year ended December 31, 1985, or on the consistency of application of accounting principles with the preceding year.

In our opinion, based upon our examination and the report of other auditors, the accompanying consolidated balance sheet presents fairly the financial position of National Motors, Inc. and subsidiaries as of December 31, 1985, in conformity with generally accepted accounting principles.

White & Co.

March 28, 1986

M86

Answer 3 (10 points)

Deficiencies in the audit assistant’s draft include the following:

1. The report is improperly addressed to the president.

2. The scope paragraph does not identify the financial statements examined, i.e., balance sheet, and statements of income, retained earnings, and changes in financial position.

3. The scope paragraph does not make reference to “other auditing procedures” after “tests of accounting records.”

4. Reference to “Note K” pertaining to a subsequent event is inappropriate in the scope paragraph. If the auditor wishes to emphasize this matter, such explanatory information should be presented in a separate paragraph of the auditor’s report.

A-92
5. There is no reference to the predecessor auditors in the scope paragraph as required when the statements are in comparative form.

6. There is no reference that an adverse opinion was expressed by the predecessor auditors.

7. The separate explanatory paragraph does not make reference to the requirements of generally accepted accounting principles, i.e., property and equipment should be stated at an amount not in excess of cost, and deferred income taxes should be provided. Therefore, all of the substantive reasons for the adverse opinion have not been disclosed.

8. The separate explanatory paragraph does not disclose either the monetary effects of the violations of generally accepted accounting principles or that the effects are not reasonably determinable.

9. The opinion paragraph does not include a direct reference to the separate explanatory paragraph that discloses the basis for the adverse opinion.

10. The opinion paragraph does not make reference to “conformity with generally accepted accounting principles.”

11. No reference to consistency should be made in the opinion paragraph when an adverse opinion is issued; an opinion as to consistency implies the application of generally accepted accounting principles.

12. The auditor’s report is not properly dual dated.

M85

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

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.
3. It incorporates the financial statements into the auditor’s report when such an incorporation, by reference or otherwise, is inappropriate.
4. There is no mention of the examination including “tests of the accounting records.”

Middle paragraph

1. The date of the previous auditor’s report is not specified.
2. The type of opinion previously expressed is not specified.
3. Inclusion of the phrase “our attorney’s meritorious defense” is inappropriate.
4. The substantive reasons for the change in opinion(s) are not disclosed.

Opinion paragraph

1. The phrase “based upon the preceding” in the opinion is inappropriate and may be interpreted as a qualification.
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.

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.
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, 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

N84

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 Cor-
poration 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

N83
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.

B. Other Reporting Considerations

N85
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 & Dee to discuss Dey & Dee's audit procedures or a review of Dey & Dee's audit programs and/or working papers. In addition, May & 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.
Business Law

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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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MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons

N86#1. Starr Corp. approved a plan of merger with Silo Corp. One of the determining factors in approving the merger was the strong financial statements of Silo which were audited by Cox & Co., CPAs. Starr had engaged Cox to audit Silo's financial statements. While performing the audit, Cox failed to discover certain irregularities which have subsequently caused Starr to suffer substantial losses. In order for Cox to be liable under common law, Starr at a minimum must prove that Cox
   a. Acted recklessly or with a lack of reasonable grounds for belief.
   b. Knew of the irregularities.
   c. Failed to exercise due care.
   d. Was grossly negligent.

N86#2. In which of the following statements concerning a CPA firm's action is scienter or its equivalent absent?
   a. Actual knowledge of fraud.
   b. Performance of substandard auditing procedures.
   c. Reckless disregard for the truth.
   d. Intent to gain monetarily by concealing fraud.

N86#3. 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 CPA did not financially benefit from the alleged fraud.
   b. The contributory negligence of the client.
   c. The stockholder lacks privity to sue.
   d. The false statements were immaterial.

N86#4. Ritz Corp. wished to acquire the stock of Stale, Inc. In conjunction with its plan of acquisition Ritz hired Fein, CPA, to audit the financial statements of Stale. Based on the audited financial statements and Fein's unqualified opinion, Ritz acquired Stale. Within six months, it was discovered that the inventory of Stale had been overstated by $500,000. Ritz commenced an action against Fein. Ritz believes that Fein failed to exercise the knowledge, skill, and judgment commonly possessed by CPAs in the locality, but is not able to prove that Fein either intentionally deceived it or showed a reckless disregard for the truth. Ritz also is unable to prove that Fein had any knowledge that the inventory was overstated. Which of the following two causes of action would provide Ritz with proper bases upon which Ritz would most likely prevail?
   b. Negligence and gross negligence.
   c. Negligence and fraud.
   d. Gross negligence and breach of contract.

N86#5. In a common law action against an accountant, the lack of privity is a viable defense if the plaintiff
   a. Is a creditor of the client who sues the accountant for negligence.
   b. Can prove the presence of gross negligence which amounts to a reckless disregard for the truth.
   c. Is the accountant's client.
   d. Bases his action upon fraud.

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.
B-2

Negligence

Yes

Yes

the

failure

fense?

opinion

following

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. 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.

B. Federal Statutory Liability

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 negligent. 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 presumed 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.

N83#6. Sharp & Co., CPAs, was engaged by Radar Corp. to audit its financial statements. Sharp issued an unqualified opinion on Radar's financial statements. Radar has been accused of making negligent misrepresentations in the financial statements which Wisk relied upon when purchasing Radar stock. Sharp was not aware of the misrepresentations nor was it negligent in performing the audit. If Wisk sues Sharp for damages based upon Section 10(b) and Rule 10 b-5 of the Securities Exchange Act of 1934, Sharp will

a. Lose, since the statements contained negligent misrepresentations.

b. Lose, since Wisk relied upon the financial statements.

c. Prevail, since some element of scienter must be proved.

d. Prevail, since Wisk was not in privity of contract with Sharp.

N83#7. On July 1, 1986, Kent purchased common stock of Salem Corp. in an offering subject to the Securities Act of 1933. Mane & Co., CPAs, rendered an unqualified opinion on the financial statements of Salem which were included in Salem's registration statement filed with the SEC on March 1, 1986. Kent has commenced an action against Mane based on the Securities Act of 1933 provisions dealing with omissions of facts required to be stated in the registration statement. Which of the following elements of a cause of action under the Securities Act of 1933 must be proved by Kent?

a. Kent relied upon Mane's opinion.

b. Kent was the initial purchaser of the stock and gave value for it.

c. Mane's omission was material.

d. Mane acted negligently or fraudulently.

N83#8. Lee, CPA, prepared Sly's 1985 federal income tax return. Sly gave Lee a list of purported 1985 contributions to various recognized charities, totaling $18,000. In fact, Sly had actually contributed only $2,000 to charities during 1985. Based on Sly's list, Lee deducted $18,000 for contributions in Sly's 1985 return,
resulting in a tax understatement of about $8,000. Sly's total tax liability shown on the return was $65,000. Lee had no reason to doubt the accuracy of Sly's figures, although Lee did not request supporting documentation. In connection with Lee's preparation of Sly's 1985 return, Lee is subject to
a. An automatic IRS penalty of $100.
b. An automatic IRS penalty of $500.
c. A 5% negligence penalty.
d. No IRS penalty.

**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

<table>
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<th>Damages</th>
<th>Materiality of the misstatement</th>
<th>Kosson's scienter</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
<td>Yes</td>
<td>No</td>
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<td>c. Yes</td>
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<td>d. No</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 expenses incurred by the cash basis taxpayer.
c. Claims a substantial deduction for a loss resulting 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 representations, 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 claimed; but he was assured by Pym that sufficient corroborative 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.
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.

C. Workpapers, Privileged Communication, and Confidentiality

In general, which of the following statements is correct with respect to ownership, possession, or access to workpapers prepared by a CPA firm in connection with an audit?

a. The workpapers may be obtained by third parties where they appear to be relevant to issues raised in litigation.
b. The workpapers are subject to the privileged communication rule which, in a majority of jurisdictions, prevents third-party access to the workpapers.
c. The workpapers are the property of the client after the client pays the fee.
d. The workpapers must be retained by the CPA firm for a period of ten years.

The accountant-client privilege is recognized

a. Only if the action involved is in federal court.
b. Where a state statute has been enacted creating such a privilege.
c. By virtue of the common law in the majority of states.
d. In the majority of states as a result of legislative enactment and court adoption.

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.

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.

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.
Selected Questions

II. Business Organizations

A. Agency

M87#4. A general agent’s apparent authority to bind her principal to contracts with third parties will cease without notice to those third parties when the
a. Agent has fulfilled the purpose for which the agency relationship was created.
b. Time set forth in the agreement creating the agency relationship has expired.
c. Principal and agent have mutually agreed to end their relationship.
d. Principal has received a discharge in bankruptcy under the liquidation provisions of the Bankruptcy Code.

M87#5. If an agent has, within the scope of the agency relationship, committed both negligent and intentional acts resulting in injury to third parties, the principal
a. May be liable even if the agent’s acts were unauthorized.
b. May effectively limit its liability to those third parties if the agent has signed a disclaimer absolving the principal from liability.
c. Will be liable under the doctrine of respondeat superior only for the intentional acts.
d. Will never be criminally liable unless it actively participated in the acts.

M87#6. Starr is an agent of a disclosed principal, Maple. On May 1, Starr entered into an agreement with King Corp. on behalf of Maple that exceeded Starr’s authority as Maple’s agent. On May 5, King learned of Starr’s lack of authority and immediately notified Maple and Starr that it was withdrawing from the May 1 agreement. On May 7, Maple ratified the May 1 agreement in its entirety. If King refuses to honor the agreement and Maple brings an action for breach of contract, Maple will
a. Prevail since the agreement of May 1 was ratified in its entirety.
b. Prevail since Maple’s capacity as a principal was known to Starr.
c. Lose since the May 1 agreement is void due to Starr’s lack of authority.
d. Lose since King notified Starr and Maple of its withdrawal prior to Maple’s ratification.

M86#59. Borg is the vice-president of purchasing for Crater Corp. He has authority to enter into purchase contracts on behalf of Crater provided that the price under a contract does not exceed $2 million. Dent, who is the president of Crater, is required to approve any contract that exceeds $2 million. Borg entered into a $2.5 million purchase contract with Shady Corp. without Dent’s approval. Shady was unaware that Borg exceeded his authority. Neither party substantially changed its position in reliance on the contract. What is the most likely result of this transaction?
  a. Crater will be bound because of Borg’s apparent authority.
  b. Crater will not be bound because Borg exceeded his authority.
  c. Crater will only be bound up to $2 million, the amount of Borg’s authority.
  d. Crater may avoid the contract since Shady has not relied on the contract to its detriment.

M86#60. Cox engaged Datz as her agent. It was mutually agreed that Datz would not disclose that he was acting as Cox’s agent. Instead he was to deal with prospective customers as if he were a principal acting on his own behalf. This he did and made several contracts for Cox. Assuming Cox, Datz or the customer seeks to avoid liability on one of the contracts involved, which of the following statements is correct?
  a. Cox must ratify the Datz contracts in order to be held liable.
  b. Datz has no liability once he discloses that Cox was the real principal.
  c. The third party can avoid liability because he believed he was dealing with Datz as a principal.
  d. The third party may choose to hold either Datz or Cox liable.

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#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
**Selected Questions**

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.

**N83#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.

**B. Partnerships and Joint Ventures**

**M87** Items 7 through 9 are based on the following information:

White, Grey, and Fox formed a limited partnership. White is the general partner and Grey and Fox are the limited partners. Each agreed to contribute $200,000. Grey and Fox each contributed $200,000 in cash while White contributed $150,000 in cash and $50,000 worth of services already rendered. After two years, the partnership is insolvent. The fair market value of the assets of the partnership is $150,000 and the liabilities total $275,000. The partners have made no withdrawals.

7. If Fox is insolvent and White and Grey each has a net worth in excess of $300,000, what is White’s maximum potential liability in the event of a dissolution of the partnership?

a. $62,500  
b. $112,500  
c. $125,000  
d. $175,000

8. Unless otherwise provided in the certificate of limited partnership, which of the following is correct if Fox assigns her interest in the partnership to Barr and only White consents to Barr’s admission as a limited partner?

a. Barr will not become a substituted limited partner unless Grey also consents.  
b. Barr will have the right to inspect the partnership’s books.  
c. The partnership will be dissolved.  
d. Barr will become a substituted limited partner because White, as general partner, consented.

9. Unless otherwise provided in the certificate of limited partnership, which of the following is correct if Grey dies?

a. Grey’s executor will automatically become a substituted limited partner.  
b. Grey’s executor will have all the rights of a limited partner for the purpose of settling the estate.  
c. The partnership will automatically be dissolved.  
d. Grey’s estate will be free from any liabilities which may have been incurred by Grey as a limited partner.
**Business Law**

**M87#10.** With respect to the following matters, which is correct if a general partnership agreement is silent?

- a. A partnership will continue indefinitely unless a majority of the partners votes to dissolve the partnership.
- b. Partnership losses are allocated in the same proportion as partnership profits.
- c. A partner may assign his interest in the partnership but only with the consent of the other partners.
- d. A partner may sell the goodwill of the partnership without the consent of the other partners when the sale is in the best interest of the partnership.

**M86**

**Items 55 and 56** are based on the following information:

Ted Fein, a partner in the ABC Partnership, wishes to withdraw from the partnership and sell his interest to Gold. All of the other partners in ABC have agreed to admit Gold as a partner and to hold Fein harmless for the past, present, and future liabilities of ABC. A provision in the original partnership agreement states that the partnership will continue upon the death or withdrawal of one or more of the partners.

55. As a result of Fein's withdrawal and Gold's admission to the partnership, Gold

- a. Is personally liable for partnership liabilities arising before and after his admission as a partner.
- b. Has the right to participate in the management of ABC.
- c. Acquired only the right to receive Fein's share of the profits of ABC.
- d. Must contribute cash or property to ABC in order to be admitted with the same rights as the other partners.

56. The agreement to hold Fein harmless for all past, present, and future liabilities of ABC will

- a. Prevent partnership creditors from holding Fein personally liable only as to those liabilities of ABC existing at the time of Fein's withdrawal.
- b. Prevent partnership creditors from holding Fein personally liable for the past, present, and future liabilities of ABC.
- c. Not affect the rights of partnership creditors to hold Fein personally liable for those liabilities of ABC existing at the time of his withdrawal.
- d. Permit Fein to recover from the other partners only amounts he has paid in excess of his proportionate share.

**M86#57.** Todd and Reed entered into a written partnership agreement to operate a retail clothing store. Their agreement was silent as to the duration of the partnership. Todd wishes to dissolve the partnership. Which of the following statements is correct?

- a. Todd may dissolve the partnership at any time.
- b. Todd may dissolve the partnership only after notice of the proposed dissolution is given to all partnership creditors.
- c. Todd may not dissolve the partnership unless Reed consents.
- d. Todd must apply to a court and obtain a decree ordering the dissolution unless Reed consents.

**M86#58.** Noll Corp. and Orr Co. are contemplating entering into an unincorporated joint venture. Such a joint venture

- a. Will be treated as a partnership in most important legal respects.
- b. Must be dissolved upon completion of a single undertaking.
- c. Will be treated as an association for federal income tax purposes and taxed at the prevailing corporate rates.
- d. Must file a certificate of limited partnership with the appropriate state agency.

**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 subsequent 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.
Selected Questions

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, $1/3 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 Items 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:

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Trade accounts receivable</td>
<td>35,000</td>
</tr>
<tr>
<td>Receivable from Darla</td>
<td>25,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$200,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade accounts payable</td>
<td>$410,000</td>
</tr>
</tbody>
</table>

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.
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.

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.

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.

For which of the following purposes is a general partnership recognized as an entity by the Uniform Partnership Act?

a. Recognition of the partnership as the employer of its partners.

b. Insulation of the partners from personal liability.

c. Taking of title and ownership of property.

d. Continuity of existence.

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.

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.

The corporate veil is most likely to be pierced and the shareholders held personally liable if

a. An ultra vires act has been committed.

b. The corporation has elected S corporation status under the Internal Revenue Code.

c. A partnership incorporates its business solely to limit the liability of its partners.

d. The shareholders have commingled their personal funds with those of the corporation.

West owns 5,000 shares of $7 cumulative preferred stock of Sky Corp. During the first year of operations, cash dividends of $7 per share were declared on Sky's preferred stock but were never paid. In the second year of operations, dividends on Sky's preferred stock were neither declared nor paid. If Sky is dissolved, which of the following statements is correct?

a. West will have priority over the claims of Sky's debenture bond owners.

b. West will have priority over the claims of Sky's unsecured judgment creditors.

c. Sky will be liable to West as an unsecured creditor for $35,000.

d. Sky will be liable to West as an unsecured creditor for $70,000.
Selected Questions

M87#3. In general, which of the following must be contained in articles of incorporation?
   a. The names of states in which the corporation will be doing business.
   b. The name of the state in which the corporation will maintain its principal place of business.
   c. The names of the initial officers and their terms of office.
   d. The classes of stock authorized for issuance.

N85#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.

N85 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 in 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.

N85#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.

M85#11. Which of the following is a correct statement concerning the similarities of a limited partnership and a corporation?
   a. Both are recognized for federal income tax purposes as taxable entities.
   b. Both can only be created pursuant to a statute and each must file a copy of its certificate with the proper state authorities.
   c. Both provide insulation from personal liability for all of the owners of the business.
   d. 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. A director's fiduciary duty to the corporation may be discharged by merely disclosing his self-interest.
   b. A director owes a fiduciary duty to the shareholders but not to the corporation.
   c. A promoter of a corporation to be formed owes no fiduciary duty to anyone, unless the contract engaging the promoter so provides.
   d. A majority shareholder as such may owe a fiduciary duty to fellow shareholders.

M85#14. Generally, officers of a corporation
   a. Are elected by the shareholders.
   b. Are agents and fiduciaries of the corporation, having actual and apparent authority to manage the business.
   c. May be removed by the board of directors without cause only if the removal is approved by a majority vote of the shareholders.
   d. May declare dividends or other distributions to shareholders as they deem appropriate.
**Business Law**

**M85#15.** The essential difference between a stock dividend and a stock split is that a

a. Stock split will increase the amount of stockholders' equity.

b. Stock split will increase a stockholder's percentage of ownership.

c. Stock dividend must be paid in the same class of stock as held by the stockholder.

d. Stock dividend of newly issued shares will result in a decrease in retained earnings.

**M85#19.** 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.

**M85#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.

**M85#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.

N83#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.

D. Estates and Trusts

M86#51. Ed Roth, a retired businessman, plans to travel extensively during the upcoming year. Roth is concerned that he may not be able to handle the daily activities associated with his financial affairs. As a solution, Roth created a trust and transferred most of his investment assets to Long Bank, as trustee, naming himself as the trust’s sole beneficiary. Which of the following statements is correct?

a. The trust is invalid under the merger doctrine since the creator and the beneficiary are the same person.
b. Long has a fiduciary duty to the trust but not to Roth as beneficiary.
c. Roth has created a testamentary trust.
d. Roth has created an inter vivos trust.

M86#52. Ryan is the trustee of the Carr Family Trust. The assets of the trust are various income-producing real estate properties. The trust instrument is silent as to the allocation of items between principal and income. Among the items to be allocated by Ryan during the first year were depreciation and the cost of a new roof. Which are properly allocable to income?

<table>
<thead>
<tr>
<th>Depreciation</th>
<th>Cost of a new roof</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. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M86#53. Which of the following statements is correct with respect to a trustee?

a. The trustee is liable for losses which result from a delegation of any duty by him.
b. The trustee can not purchase property from the trust even if the trust instrument authorizes it.
c. In the absence of a provision otherwise in the trust instrument, the trustee has the responsibility to invest the trust property so as to produce income.
d. The trustee will be free from personal liability with regard to all contracts entered into by him on behalf of the trust and on debts incurred by the trust.

M85#54. Okun, a major shareholder in Stale Corp., placed all of his shares of stock in a trust for the benefit of his three children. The purpose of the trust was to provide an entity through which the dividends paid on the stock would pass to his children for their lives. The trust instrument was silent as to whether Okun may terminate the trust. If Okun wishes to terminate the trust, he may

a. Not do so since the trust instrument is silent on this point.
b. Not do so since a trust may only be terminated with court permission.
c. Do so since such a right is impliedly reserved by Okun.
d. Do so only if the trustee also agrees to terminate the trust.

M85#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.

M85#59. Fine wishes to establish an inter vivos trust for the benefit of her 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.
A. Offer and Acceptance

M87#11. On April 2, 1987, Bonn & Co., CPAs, mailed Marble Corp. a signed proposal to perform certain accounting services for Marble provided Marble accepts the proposal by April 30, 1987. Under the circumstances,
   a. If Marble accepts by telephone on April 30, 1987, no contract will be formed between the parties.
   b. Marble must accept the Bonn proposal in writing in order to form a contract.
   c. A contract will be formed between the parties if Marble mails an acceptance to Bonn on April 29, 1987, even if it is not received by Bonn until May 3, 1987.
   d. Bonn may not withdraw its proposal prior to May 1, 1987.

M87#12. Beal offered in writing to sell Crane a parcel of land for $150,000. If Beal dies, the offer will
   a. Automatically terminate prior to Crane's acceptance.
   b. Automatically terminate despite Crane's prior acceptance.
   c. Terminate prior to Crane's acceptance only if Crane received notice of Beal's death.
   d. Remain open for a reasonable period of time after Beal's death.

M87 Items 15 and 16 are based on the following information:

On March 1, Mirk Corp. wrote to Carr offering to sell Carr its office building for $280,000. The offer stated that it would remain open until July 1. It further stated that acceptance must be by telegram and would be effective only upon receipt.

15. For this question only, assume that Carr telegraphed its acceptance on June 28 and that it was received by Mirk on July 2. Which of the following statements is correct?
   a. A contract was formed when Carr telegraphed its acceptance.
   b. A contract was formed when Mirk received Carr's acceptance.
   c. No contract was formed because three months had elapsed since the offer was made.
   d. No contract was formed since the acceptance was received after July 1.

16. For this question only, assume that on May 10, Mirk mailed a letter to Carr revoking its offer of March 1. Carr did not learn of Mirk's revocation until Carr received the letter on May 17. Carr had already sent a telegram of acceptance to Mirk on May 14, which was received by Mirk on May 16. Which of the following statements is correct?
   a. Mirk's telegram of acceptance was effective on May 16.
   b. Mirk's offer of March 1 was irrevocable and therefore could not be withdrawn prior to July 1.
   c. Mirk's letter of revocation effectively terminated its offer of March 1 when mailed.
   d. Carr's telegram of acceptance was effective on May 14.

N86#12. Stable Corp. offered in a signed writing to sell Mix an office building for $350,000. The offer, which was sent by Stable on April 1, indicated that it would remain open until July 9. On July 5, Mix mailed a letter rejecting Stable's offer. On July 6, Mix sent a telegram to Stable accepting the original offer. The letter of rejection was received by Stable on July 8 and the telegram of acceptance was received by Stable on July 7. Which of the following is correct?
   a. Mix's telegram resulted in the formation of a valid contract.
   b. Mix's letter of July 5 terminated Stable's offer when mailed.
   c. Stable was not entitled to withdraw its offer until after July 9.
   d. Although Stable's offer on April 1 was a firm offer under the UCC it will only remain open for three months.

N86#15. Kraft Corp. published circulars containing price quotes and a description of products which it would like to sell. Rice, 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. Kraft must sell the product which Rice demands at the quoted price.
   b. Rice has accepted Kraft's firm offer to sell.
   c. Kraft has made an offer.
   d. Rice has made an offer.

M86#1. Ted Marx sent Stahl & Co. a signed letter on January 3, 1986 offering to sell his warehouse for $95,000. The letter indicated that the offer would remain open until January 30, 1986. On January 26, Stahl wrote Marx that it would be willing to pay $88,000 for the warehouse. The letter was received by Marx on January 29. On January 28, Stahl was advised that a similar property had been sold for $99,000. Based on this information, Stahl telephoned Marx on January 28.
and accepted the original offer of January 3. Marx refused to sell the warehouse to Stahl for $95,000. Which of the following statements is correct?

a. Stahl’s acceptance on January 28 formed a contract which bound Marx to the terms of his original offer.
b. Marx’s letter dated January 3 is a firm offer under the UCC.
c. Stahl is barred under the parol evidence rule from introducing evidence of its oral acceptance since it contradicts its letter dated January 26.
d. A contract was never formed since Stahl’s letter of January 26 was a counteroffer which terminated Marx’s offer when mailed.

**M86#2.** Able Sofa, Inc., sent Noll a letter offering to sell Noll a custom made sofa for $5,000. Noll immediately sent a telegram to Able purporting to accept the offer. However, the telegraph company erroneously delivered the telegram to Abel Soda, Inc. Three days later, Able mailed a letter of revocation to Noll which was received by Noll. Able refused to sell Noll the sofa. Noll sued Able for breach of contract. Able

a. Would have been liable under the deposited acceptance rule only if Noll had accepted by mail.
b. Will avoid liability since it revoked its offer prior to receiving Noll’s acceptance.
c. Will be liable for breach of contract.
d. Will avoid liability due to the telegraph company’s error.

**N85#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.

**N85#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.

**N85#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.

**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#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.
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

- Ed’s statement: “I suppose $400 would be a fair price” constituted an offer.
- Mary’s reply: “I’ll take it, if you will have it refinished” was a conditional acceptance, terminating Ed’s offer.
- No contract resulted since Ed never stated he would actually sell the table for $400.
- A contract was formed when Ed said: “Sold.”

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?

- Martin’s mailing of $100 to Lemon on January 5 failed to create an option.
- Martin’s communication of January 30 automatically terminated Lemon’s offer of January 1.
- The placing of the ranch on the market by Lemon constituted an effective revocation of his offer of January 1.
- Martin’s letter of February 6 formed a binding contract based on the original terms of Lemon’s January 1 letter.

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 Grand’s 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

- The Grands have made an offer to buy a lot from Dome.
- If all the lots are sold by Dome, the Grands have a cause of action for breach of contract.
- If no deal is ever consummated, the Grands have the right to the return of the $100.
- The $100 constitutes liquidated damages and will be forfeited in the event the Grands do not purchase a lot.

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

- West’s letter was a firm offer as defined under the Uniform Commercial Code.
- Baker validly accepted on the morning of October 26.
- There is no contract since Baker’s acceptance was not in a signed writing.
- The parol evidence rule will preclude Baker from contradicting his written statements with oral testimony contra to his letter of October 25.

In determining whether a bilateral contract has been created, the courts look primarily at

- The fairness to the parties.
- The subjective intent of the parties.
- The subjective intent of the offeror.

Justin made an offer to pay Benson $1,000 if Benson would perform a certain act. Acceptance of Justin’s offer occurs when Benson

- Promises to complete the act.
- Prepares to perform the act.
- Promises to perform and begins preliminary performance.
- Completes the act.

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

- Harmon’s telegram effectively terminated the offer.
- Harmon’s oral acceptance is voidable, because real estate is involved.
- The offer was revoked as a result of Harmon’s learning that others were interested in purchasing the business.
- Harmon has made a valid contract at $200,000.
Selected Questions

B. Consideration

M87#14. Which of the following will be legally binding on all the parties despite the lack of consideration?
   a. A promise to donate money to a charity which was relied upon by the charity in incurring large expenditures.
   b. An oral employment agreement for a term of nine months from the date the agreement was formed.
   c. An irrevocable oral promise by a merchant to keep its offer open for 60 days.
   d. A material modification signed by the parties to a contract to purchase and sell a parcel of land.

M87#17. In order to satisfy the consideration requirement to form a contract, the consideration exchanged by the parties must
   a. Have a monetary value.
   b. Conform to the parties' subjective intent.
   c. Be legally sufficient.
   d. Have approximately the same value.

M86#11. Which of the following requires consideration in order to be binding on the parties?
   a. A written promise signed by a merchant to keep an offer to sell goods open for 10 days.
   b. Material modification of a sale of goods contract under the UCC.
   c. Ratification of a contract by a person after reaching the age of majority.
   d. Material modification of a contract involving the sale of real estate.

M86#3. Polk is seeking to avoid performing a promise to pay Lake $800. Polk is relying upon lack of consideration on Lake's part sufficient to support his promise. Polk will prevail if he can establish that
   a. Lake's only claim of consideration was the relinquishment of a legal right.
   b. Prior to Polk's promise, Lake had already performed the requested act.
   c. The contract is executory.
   d. Lake's asserted consideration is worth only $250.

N85#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.

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.

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.

C. Capacity, Legality, and Public Policy

M87#18. Wert, an employee of Salam Corp., signed an agreement not to compete with Salam during and after being employed with Salam. Wert is the director of research and has knowledge of many of Salam's trade secrets. If Wert's employment with Salam is terminated and Wert wishes to compete with Salam, which of the following statements is not correct?
   a. The agreement is only enforceable if Wert voluntarily terminates his employment with Salam.
   b. The agreement must be necessary to protect Salam's legitimate interests in order to be enforceable.
   c. The geographic area covered by the agreement must be reasonable in order to be enforceable.
   d. The court will consider Wert's ability to obtain other employment against Salam's right to protect its business.
**Business Law**

**N86#13.** Meed entered into a written agreement to sell a parcel of land to Beel for $80,000. At the time the agreement was executed, Meed had consumed a large amount of alcoholic beverages which significantly impaired Meed’s ability to understand the nature and terms of the contract. Beel knew Meed was very intoxicated and that the land had been appraised at $125,000. Meed wishes to avoid the contract. The contract is:

a. Void.

b. Legally binding on both parties in the absence of fraud or undue influence.

c. Voidable at Meed’s option.

d. Voidable at Meed’s option only if the intoxication was involuntary.

**N86#14.** Samm, a plumber, entered into a contract for $75,000 with Orr, Inc., to perform certain plumbing services in a building owned by Orr. After Samm had satisfactorily performed the work, Orr discovered that Samm had violated the state licensing statute by failing to obtain a plumbing license. The licensing statute was enacted merely to raise revenue for the state. An independent appraisal of Samm’s work indicated that the building’s fair market value increased by $70,000 as a result of Samm’s work. The cost of the materials which Samm supplied was $35,000. If Samm sues Orr, Samm will be entitled to recover:

a. $0

b. $35,000

c. $70,000

d. $75,000

**N86#4.** On May 1, 1985, Mint, a 16-year-old, purchased a sailboat from Sly Boats. Mint used the boat for six months at which time he advertised it for sale. Which of the following statements is correct?

a. The sale of the boat to Mint was void, thereby requiring Mint to return the boat and Sly to return the money received.

b. The sale of the boat to Mint may be avoided by Sly at its option.

c. Mint’s use of the boat for six months after the sale on May 1 constituted a ratification of that contract.

d. Mint may disaffirm the May 1 contract at any time prior to reaching majority.

**N86#5.** Todd is a licensed real estate broker in Ohio. One of Todd’s largest clients, Sun Corp., contracted in writing with Todd to find a purchaser for its plant in New York and agreed to pay him a 6% commission if he were successful. Todd located a buyer who purchased the plant. Unknown to Todd, New York has a real estate broker’s licensing statute which is regulatory in nature, intended to protect the public against unqualified persons. Todd violated the licensing statute by failing to obtain a New York license. If Sun refuses to pay Todd any commission and Todd brings an action against Sun, he will be entitled to recover:

a. Nothing.

b. A fee based on the actual hours spent.

c. The commission agreed upon.

d. Out of pocket expenses only.

**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.

**N84#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.

**N83#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.
D. Statute of Frauds

M87#13. On April 2, 1986, Streb entered into an oral employment contract with Xeon, Inc. for a term of three years at a salary of $2,000 per week. On June 10, 1986, Streb was terminated by Xeon. On July 10, 1986, Streb commenced an action for breach of the employment contract. Xeon has asserted the statute of frauds as a defense. On July 30, 1986, Streb died. Under the circumstances, the employment contract is
a. Unenforceable since the value of the consideration given exceeds $500.
b. Unenforceable since it was not in writing and signed by Xeon.
c. Enforceable since it was possible that the contract could have been performed within one year from the making of the contract.
d. Enforceable since Streb's death occurred within one year from the making of the contract.

N86#16. Stahl Corp. entered into a written contract to purchase a warehouse from Mehl for $85,000. Thereafter, Mehl received an offer from another purchaser to buy the warehouse for $95,000. As a result, Mehl has refused to transfer the warehouse to Stahl. Stahl has commenced an action for specific performance. Mehl has raised the statute of frauds as a defense. In order for Stahl to successfully prevail on the statute of frauds issue, it must be shown among other requirements that the contract was signed by
a. Mehl.
b. Stahl.
c. Mehl and Stahl at the same time.
d. Mehl and Stahl with proper notarizations affixed to the contract.

M86#6. On April 3, 1985, Fier entered into an oral employment contract with Reich, whereby Reich was hired as a sales manager for a term of one year. Although Fier and Reich did not agree to a definite starting date, Fier indicated that Reich could begin employment that same day or any time prior to April 15, 1985. Reich began working on April 10. On June 15, 1985, Reich was fired without cause. If Reich sues for breach of the employment contract and Fier asserts the statute of frauds as a defense, Reich will
a. Prevail since the contract was capable of being performed within one year.
b. Prevail since the UCC statute of frauds applies.
c. Lose since the contract was not in writing and signed by Fier.
d. Lose since Reich did not begin employment until April 10.

N85#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.

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

N86#17. Sklar, CPA, purchased from Wiz Corp. two computers. Sklar discovered material defects in the computers 10 months after taking delivery. Three years
after discovering the defects, Sklar commenced an action for breach of warranty against Wiz. Wiz has raised the statute of limitations as a defense. The original contract between Wiz and Sklar contained a conspicuous clause providing that the statute of limitations for breach of warranty actions would be limited to 18 months. Under the circumstances, Sklar will
a. Win because the action was commenced within the four-year period as measured from the date of delivery.
b. Win because the action was commenced within the four-year period as measured from the time he discovered the breach or should have discovered the breach.
c. Lose because the clause providing that the statute of limitations would be limited to 18 months is enforceable.
d. Lose because the statute of limitations is three years from the date of delivery with respect to written contracts.

M86#7. Simon has been sued by Major for breach of a real estate contract. Simon has raised the statute of limitations as a defense to Major's lawsuit. Under the circumstances, the statute of limitations
a. Runs continuously under all circumstances commencing at the time the contract is breached.
b. Does not apply to the contract between Simon and Major because it involves real estate.
c. Will prevent recovery where the time set forth in the statute has expired.
d. Is four years in all states.

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.

F. Fraud, Duress, and Undue Influence

M87#19. Baker fraudulently induced Able to sell Baker a painting for $200. Subsequently, Baker sold the painting for $10,000 to Gold, a good faith purchaser. Able is entitled to
a. Rescind the contract with Baker.
b. Recover the painting from Gold.
c. Recover damages from Baker.
d. Rescind Baker's contract with Gold.

M87#20. In order for a purchaser of land to avoid a contract with the seller based on duress, it must be shown that the seller's improper threats
a. Constituted a crime or tort.
b. Actually induced the purchaser to assent to the contract.
c. Would have induced a reasonably prudent person to assent to the contract.
d. Were made with the intent that the purchaser be influenced by them.

M86 Items 19 through 21 are based on the following information:

Bob Meyer sold a parcel of land to Sam Stein for $85,000. Meyer agreed to accept as payment Stein's promissory note in the amount of $60,000 and cash of $25,000. During the course of negotiations Stein misrepresented his financial condition. Furthermore, at the closing Stein made improper threats to Meyer when Meyer indicated he did not want to go through with the deal. As a result of the threats, Meyer did execute and deliver a deed to the land. Meyer wishes to rescind the contract and has commenced an action based upon common law fraud, duress, and innocent misrepresentation. Meyer's complaint contains the following allegations:

I. Stein materially misrepresented his financial condition.
II. Stein had actual or constructive knowledge that the representations made during the negotiations were false.
III. Meyer entered into the contract because of Stein's improper threats.
IV. Meyer justifiably relied upon Stein's false representations made during the negotiations.
V. Meyer suffered physical harm as a result of the improper threats.

19. Which statements contained in Meyer's complaint are necessary to establish the action for common law fraud?
   a. I and II only.
   b. I and IV only.
   c. II and IV only.
   d. I, II, and IV.

20. Which statement(s) contained in Meyer's complaint would be necessary to establish the action for duress?
   a. III only.
   b. III and IV.
   c. III and V.
   d. V only.

M86#8. Sardy, a famous football player, was asked to autograph a pad of paper held by Maple. Unknown to Sardy, Maple had carefully concealed a contract for the
sale of Sardy’s home to Maple in the pad which Sardy signed. If Maple seeks to enforce the contract, Sardy’s best defense to have the contract declared void would be

   a. Fraud in the inducement.
   b. Fraud in the execution.
   c. Mistake.
   d. Duress.

M86#10. Carter owns a parcel of land. Smith, one of Carter’s closest friends and an attorney, has persuaded Carter to sell the land to Smith at a price substantially below fair market value. At the time Carter sold the land he was resting in a nursing home recovering from a serious illness. If Carter desires to set aside the sale, which of the following causes of action is most likely to be successful?

   a. Duress.
   b. Undue influence.
   c. Fraud.
   d. Misrepresentation.

N85#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 the contract as the result of an improper threat by the defendant.

N85#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.

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.

G. Mistake and Misrepresentation

M87#22. Sting Corp., a general contractor, obtained bids from several plumbers to install piping. Lite, a licensed plumber, submitted a bid for $60,000 which was $20,000 less than the next lowest bid. Lite made an obvious and substantial arithmetical error in his bid. Sting did not have actual knowledge of Lite’s mistake. If Sting accepts Lite’s bid, Lite

   a. Must perform the contract for $60,000 since Sting did not have actual knowledge of the error.
   b. Must perform the contract for $60,000 unless he can show that Sting caused the error.
   c. Can avoid liability for refusing to install the piping for $60,000 since Sting should have known of Lite’s error.
   d. Can avoid liability for refusing to install the piping for $60,000 only if the error was not due to his negligence.

N86 Items 19 through 21 are based on the following information:

Bob Meyer sold a parcel of land to Sam Stein for $85,000. Meyer agreed to accept as payment Stein’s promissory note in the amount of $60,000 and cash of $25,000. During the course of negotiations Stein misrepresented his financial condition. Furthermore, at the closing Stein made improper threats to Meyer when Meyer indicated he did not want to go through with the deal. As a result of the threats, Meyer did execute and deliver a deed to the land. Meyer wishes to rescind the contract and has commenced an action based upon common law fraud, duress, and innocent misrepresentation. Meyer’s complaint contains the following allegations:

   I. Stein materially misrepresented his financial condition.
   II. Stein had actual or constructive knowledge that the representations made during the negotiations were false.
   III. Meyer entered into the contract because of Stein’s improper threats.
   IV. Meyer justifiably relied upon Stein’s false representations made during the negotiations.
   V. Meyer suffered physical harm as a result of the improper threats.
21. Which statement(s) contained in Meyer's complaint would be necessary to establish the action for innocent misrepresentation?
   a. I and II only.
   b. I, II, and IV.
   c. I and IV only.
   d. IV only.

**M86#11.** On May 6, Maple entered into a signed contract with Ard, whereby Maple was to sell Ard a painting having a fair market value of $350,000 for $130,000. Maple believed the painting was worth only $130,000. Unknown to either party the painting had been destroyed by fire on May 4. If Ard sues Maple for breach of contract, Maple's best defense is
   a. Risk of loss had passed to Ard.
   b. Lack of adequate consideration.
   c. Mutual mistake.
   d. Unconscionability.

**M85#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.

**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.

**H. Parol Evidence Rule**

**M86#22.** Reese and Wax signed a contract whereby Wax was to purchase 5,000 pens from Reese at 12¢ per pen. Subsequently, Wax in good faith requested that the price of the pens be reduced to 9¢ per pen. Reese orally agreed to reduce the price to 9¢. Under the circumstances, the oral agreement is
   a. Unenforceable due to the statute of frauds and proof of it will be inadmissible into evidence.
   b. Enforceable but proof of it will be inadmissible into evidence.
   c. Unenforceable since Wax failed to give consideration but proof of it will be otherwise admissible into evidence.
   d. Enforceable and proof of it will be admissible into evidence.

**M86#12.** Price and White entered into an all-inclusive written contract involving the purchase of a building. Their written agreement contained provisions concerning renovation work to the building to be completed by Price. This aspect of the written contract was modified by a contemporaneous oral agreement between the parties. Price relies upon the parol evidence rule to support his position that the written contract is binding on the parties. Which of the following is correct?
   a. Since the statute of frauds was satisfied in respect to the contract for the purchase of the building, the parol evidence rule does not apply.
   b. Since the oral agreement related to the same subject matter as the written contract, the parol evidence rule does not apply.
   c. White will be precluded from introducing into evidence proof of the oral agreement because of the parol evidence rule.
   d. The parol evidence rule does not apply to contemporaneous oral agreements.
Selected Questions

M85#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.

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.

M84#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.

I. Third Party Rights

M87#23. Krieg was the owner of an office building encumbered by a mortgage securing Krieg’s promissory note to Muni Bank. Park purchased the building subject to Muni’s mortgage. As a result of the sale to Park,

a. Muni is not a third party creditor beneficiary.
b. Krieg is a third party creditor beneficiary.
c. Park is liable for any deficiency resulting from a default on the note.
d. Krieg was automatically released from any liability on the note.

M86#23. Miser Corp. owned a factory which was encumbered by a mortgage securing Miser’s note to City Bank. Miser sold the factory to Sting, Inc. which assumed the mortgage note. Subsequently, Sting defaulted on the note which had an outstanding balance of $15,000. In order to recover the outstanding balance, City

a. Must sue Sting and Miser.
b. Must sue Sting first and then proceed against Miser for any deficiency.
c. May sue Sting or Miser.
d. May sue Sting only after suing Miser.

M86#13. Barr entered into a contract with Gray which required Gray to construct a warehouse on land owned by Barr. The contract specifically provided for Gray to use Apex Corp. pipe fittings for all the plumbing. Gray failed to use Apex pipe fittings. Apex had learned of the contract between Barr and Gray and, in anticipation of receiving an order from Gray, manufactured additional pipe fittings. Apex is

a. Entitled to money damages due to Gray’s breach of contract.
b. Entitled to money damages since it changed its position to its detriment by relying on the contract.
c. Not entitled to money damages since it is merely a donee beneficiary.
d. Not entitled to money damages since it is merely an incidental beneficiary.

N85

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 pro-
cceeds of the resulting foreclosure sale were less than
the outstanding balance on the note.

17. As to the contract between Sand and Quick, Se-
curity is
a. A third party creditor beneficiary.
b. A third party donee beneficiary.
c. A third party incidental beneficiary.
d. Not a beneficiary.

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 con-
tract 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 be-
nefitied from the life insurance contract.

M83#17. Nancy is asserting rights as a third party do-
nee 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 prom-
ise.
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 ben-
efit her.

J. Assignments

M87#21. On May 2, Kurtz Co. assigned its entire in-
terest in a $70,000 account receivable due in 60 days
from Long to City Bank for $65,000. On May 4, City
notified Long of the assignment. On May 7, Long in-
formed City that Kurtz had committed fraud in the
transaction out of which the account receivable arose
and that payment would not be made to City. If City
commences an action against Long and Long is able to
prove Kurtz acted fraudulently,
a. Long will be able to successfully assert fraud
as a defense.
b. City will be entitled to collect $65,000, the
amount paid for the assignment.
c. City will be entitled to collect $70,000 since
fraud in the inducement is a personal defense
which was lost on May 2.
d. City will be entitled to collect $70,000 since
Long's allegation of fraud arose after notice
of the assignment.

N86#24. Quick Corp. mailed a letter to Blue Co. on
May 1, 1986, offering a three-year franchise dealership.
The offer stated the terms in detail and at the bottom
stated that the offer would not be withdrawn prior to
June 5, 1986. Which of the following is correct?
a. The offer can not be assigned to another party
by Blue if Blue chooses not to accept.
b. A letter of acceptance from Blue to Quick
sent on June 5, 1986, and which was received
by Quick on June 6, 1986, does not create a
valid contract.
c. The offer is an irrevocable option which can
not be withdrawn prior to June 5, 1986.
d. The statute of irrevocable options does not apply to the
proposed contract.

M86#14. Sable Corp. has $500,000 of outstanding ac-
counts receivable. On July 10, 1985, Sable assigned a
$50,000 account receivable due from Baker, one of
Sable's customers, to Rich Bank for value. On July 15,
Baker paid Sable the $50,000. On July 17, Rich notified
Baker of the July 10 assignment from Sable to Rich.
Rich is entitled to collect $50,000 from
a. Sable only.
b. Baker only.
c. Neither Sable nor Baker.
d. Either Sable or Baker.

N85#6. On May 1, Apple mailed a signed offer to sell
an office building to Fein for $90,000. The offer indi-
cated 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 be-
cause 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 Ap-
ple because it was oral.
Selected Questions

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.

M86#18. Price signed a contract to sell Wyatt a parcel of land for $90,000. The entire sales price was payable at the closing. Price has decided to keep the land. If Wyatt commences an action against Price, what relief is Wyatt most likely to receive?
   a. Specific performance.
   b. Compensatory damages and specific performance.
   c. Punitive damages.
   d. Compensatory damages and punitive damages.

M86#25. Meek & Co., CPAs, was engaged by Reed, the president of Sulk Corp., to issue by June 15, 1986, an opinion on Sulk's financial statements for the fiscal year ended March 31, 1986. Meek's engagement and its fee of $20,000 were approved by Sulk's board of directors. Meek did not issue its opinion until June 30 because of Sulk's failure to supply Meek with the necessary information to complete the audit. Sulk refuses to pay Meek. If Meek sues Sulk, Meek will
   a. Prevail based on the contract.
   b. Prevail based on quasi contract.
   c. Lose, since it breached the contract.
   d. Lose, since the June 15 deadline was a condition precedent to Sulk's performance.

K. Discharge, Breach, and Remedies

M87#24. A clause in a contract for the purchase of real estate which provides that the seller shall be entitled to retain the purchaser's down payment as liquidated damages should the purchaser fail to close the transaction will generally be enforceable
   a. In addition to the seller's right to recover compensatory damages.
   b. As a penalty if the purchaser has intentionally defaulted.
   c. If the amount of the down payment bears a reasonable relationship to the probable loss.
   d. In all cases provided the parties have agreed in a signed writing.

M87#25. Lark, CPA, entered into a signed contract with Bale Corp. to perform management advisory services for Bale. If Lark repudiates the contract prior to the date performance is due to begin, which of the following is not correct?
   a. Bale could successfully maintain an action for breach of contract prior to the date performance is due to begin.
   b. Bale can obtain a judgment for the monetary damages it incurred as a result of the repudiation.
   c. Bale could successfully maintain an action for breach of contract after the date performance was due to begin.
   d. Bale can obtain a judgment ordering Lark to perform.

M86#9. Ted Nix purchased two acres of land from Sally Pine. Nix paid 15% at the closing and gave his note for the balance secured by a 30-year mortgage. Five years later, Nix found it increasingly difficult to make payments on his note and finally defaulted. Pine threatened to accelerate the loan and foreclose if Nix continued in default. Pine told Nix either to get the money or obtain an acceptable third party to assume the obligation. Nix offered the land to Quick Co. for $4,000 less than the equity Nix had in the property. This was acceptable to Pine and at the closing Quick paid the arrearage, executed a new mortgage and note, and had title transferred to its name. Pine surrendered Nix's note and mortgage to him. The transaction in question is a(an)
   a. Third party beneficiary contract.
   b. Novation.
   c. Purchase of land subject to a mortgage.
   d. Assignment and delegation.
**Business Law**

M86#15. Where the parties to a contract wish to cancel their contract and be in the same position as they were prior to forming the contract, they should seek to obtain a(an)

a. Rescission.

b. Novation.

c. Accord and satisfaction.

d. Revocation.

N85

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.

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.

N85#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.

M85#27. Bing engaged Dill to perform personal services 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.
Selected Questions

IV. Debtor-Creditor Relationships

A. Suretyship

N86#26. Which of the following defenses will release a surety from liability?
   a. Release of the principal debtor’s obligation by the creditor without the surety’s consent but with the creditor’s reservation of its rights against the surety.
   b. Modification by the principal debtor and creditor of their contract without the surety’s consent which materially increases the surety’s risk of loss.
   c. Discharge of the principal debtor in bankruptcy.
   d. Insanity of the principal debtor at the time the contract was entered into with the creditor.

N86#27. West borrowed $180,000 from Safe Bank. At the request of Safe, West had entered into an agreement with Locke, Carr, and Gold to act as co-sureties on the loan. The agreement between West and the co-sureties provided that the maximum liability of each co-surety was: Locke $36,000, Carr $54,000, and Gold $90,000. After making several payments, West defaulted on the loan. The balance was $120,000. If Gold pays $90,000 and West subsequently pays $30,000, what amount may Gold recover from Locke and Carr?
   a. $18,000 from Locke and $27,000 from Carr.
   b. $24,000 from Locke and $36,000 from Carr.
   c. $30,000 from Locke and $30,000 from Carr.
   d. $0 from Locke and $0 from Carr.

N85#28. Queen paid Pax & Co. to become the surety on a loan which Queen obtained from Squire. The loan is due and Pax wishes to compel Queen to pay Squire. Pax has not made any payments to Squire in its capacity as Queen’s surety. Pax will be most successful if it exercises its right to
   a. Reimbursement (Indemnification).
   b. Contribution.
   c. Exoneration.
   d. Subrogation.

N85#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.
**M85#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>
<th>Gray</th>
<th>Pine</th>
</tr>
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<tbody>
<tr>
<td>a.</td>
<td>$0</td>
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<tr>
<td>b.</td>
<td>$0</td>
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<tr>
<td>c.</td>
<td>$15,000</td>
</tr>
<tr>
<td>d.</td>
<td>$30,000</td>
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</tbody>
</table>

**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.

**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.

**Business Law**

**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.

**M84#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.

**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 sureties 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.**
B. Bankruptcy

M87

Items 30 and 31 are based on the following information:

On March 10, 1987, Rowe, a sole proprietor selling furniture, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. Rowe’s non-exempt property has been converted to cash which is available to satisfy the following expenses and unsecured claims as may be appropriate:

**Expenses**
Costs necessary to preserve the property of the debtor’s estate $20,000
Salary to Rowe for services rendered in operating the furniture business after the commencement of the bankruptcy action $10,000

**Unsecured Claims**
Claims by two of Rowe’s employees for wages earned within 90 days of the filing of the bankruptcy petition in the amount of $4,000 and $3,000, respectively $7,000
Claim by Acme Corp. for furniture delivered to Rowe on March 12, 1987, which was prior to the appointment of a trustee and the order for relief $30,000

30. What amount will be distributed as salary to Rowe if the cash available for distribution is $15,000?
   a. $0
   b. $5,000
   c. $7,500
   d. $10,000

31. What amount will be distributed to Acme if the cash available for distribution is $50,000?
   a. $13,000
   b. $16,000
   c. $20,000
   d. $30,000

M87#32. Which of the following is correct with respect to an involuntary bankruptcy proceeding under the liquidation provisions of the Bankruptcy Code?
   a. It may be commenced against any debtor who is insolvent.
   b. The debtor may regain possession of property in the possession of an interim trustee if the debtor files a bond.
   c. The petitioners must automatically file a bond to indemnify the debtor for any loss caused by the filing of the petition.
   d. A trustee must be elected by the creditors immediately after the court orders relief against the debtor.

M87#33. Dark Corp. is a general creditor of Blue. Blue filed a petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. Dark wishes to have the bankruptcy court either deny Blue a general discharge or not have its debt discharged. The discharge will be granted and it will include Dark’s debt even if
   a. Dark’s debt is unscheduled.
   b. Dark was a secured creditor which was not fully satisfied from the proceeds obtained upon disposition of the collateral.
   c. Blue has unjustifiably failed to preserve the records from which Blue’s financial condition might be ascertained.
   d. Blue had filed for and received a previous discharge in bankruptcy under the liquidation provisions within six years of the filing of the present petition.

M87#34. One of the elements necessary to establish that a preferential transfer has been made under the Bankruptcy Code by the debtor to a creditor is that the
   a. Debtor was insolvent at the time of the transfer.
   b. Creditor was an insider and the transfer occurred within 90 days of the filing of the bankruptcy petition.
   c. Transfer was in fact a contemporaneous exchange for new value given to the debtor.
   d. Transfer was made by the debtor with actual intent to hinder, delay, or defraud other creditors.

M87#35. Which of the following statements is correct under the Reorganization Chapter of the Bankruptcy Code if the debtor remains in possession of its business?
   I. The debtor has the right to be compensated in the same manner as a trustee.
   II. The debtor has the right to retain its own accountant to represent it despite the debtor’s employment of that accountant prior to the commencement of the Reorganization proceeding.
   a. I only.
   b. II only.
   c. I and II.
   d. Neither I nor II.

N86#29. Bill Barr filed a voluntary petition in bankruptcy. Barr will be denied a discharge in bankruptcy if he
   a. Fraudulently filed a federal income tax return two years prior to filing the petition.
   b. Obtained a loan by using financial statements which he knew were false.
   c. Negligently made preferential transfers to certain creditors within 90 days of filing the petition.
   d. Unjustifiably failed to preserve his books and records which could have been used to ascertain his financial condition.
**Business Law**

**N85#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.

**N85#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.

**N85#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.

**N85#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.

**N85#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 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.

**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:

**Expenses**

| Fees incurred to recover property belonging in the bankrupt's estate | $9,000 |
| Costs necessary to sell the property of the estate | $6,000 |

**Unsecured Claims**

| Wage claims of John Doe, earned as an employee of Frank within 61 days of the filing of the bankruptcy petition | $3,000 |
| Income taxes for the two years immediately preceding the filing of the bankruptcy petition | $80,000 |

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>
Selected Questions

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

M83#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.

M83#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.

M83#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.

M83#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.
Business Law

V. Government Regulation of Business

A. Regulation of Employment

M87#36. Nix, an employee of Fern, Inc., was injured in the course of employment while operating a drill press manufactured and sold to Fern by Jet Corp. It has been determined that Fern was negligent in supervising the operation of the drill press and that the drill press was defectively designed by Jet. If Fern has complied with the state's mandatory workers' compensation statute, Nix may

a. Not properly commence a products liability action against Jet.
b. Not obtain workers' compensation benefits.
c. Obtain workers' compensation benefits and properly maintain a products liability action against Jet.
d. Obtain workers' compensation benefits and properly maintain separate causes of action against Jet and Fern for negligence.

M87#37. The social security tax base is calculated on

b. A self-employed person's gross income from self-employment.
c. An employee's gross wages less the deduction permitted for contributions to an individual retirement account.
d. An employee's taxable income.

M87#38. The Federal Unemployment Tax Act

a. Permits an employee to receive unemployment benefits which are limited to the contributions made to that employee's account.
b. Permits an employer to take a credit against the federal unemployment tax if contributions are made to a state unemployment fund.
c. Imposes a tax on all employers doing business in the U.S.
d. Requires contributions to be made by the employer and employee equally.

M86#37. Which of the following is correct with respect to the Federal Unemployment Tax Act?

a. Employees who earn less than $7,000 are exempt from coverage.
b. Payment of the tax is shared equally by the employer and the employee.
c. A credit is generally available for contributions made by the employer to state unemployment funds.
d. Benefits to an employee cannot exceed the amount contributed to his account.

M86#38. While in the course of employment with Marco, Inc., Payne was injured. Marco has complied with the state's mandatory workers' compensation statute. Marco's workers' compensation carrier has asserted the following defenses to Payne's claim for workers' compensation benefits:

I. Marco was free from any wrongdoing.
II. Payne assumed the risk by disregarding Marco's safety procedures.
III. Payne's injury was intentionally self-inflicted.

Which defense(s) asserted by the workers' compensation carrier, if proven, will prevent Payne from recovering?

a. I only.
b. II only.
c. III only.
d. I or II.

M86#39. Social security benefits may be obtained by

a. Qualifying individuals who are also receiving benefits from a private pension plan.
b. Qualifying individuals or their families on behalf of the deceased worker.
c. Children of a deceased worker who was entitled to benefits until such children reach age 25 or complete their education, whichever occurs first.
d. Only those individuals who have made payments while employed.

M86#16. With respect to federal unemployment taxes and unemployment compensation, which of the following statements is correct?

a. The Federal Unemployment Tax Act requires both the employer and employee to make payments to an approved state unemployment fund.
b. Federal unemployment taxes are offset by a credit equal to the amount the employer contributes to an approved state unemployment fund.
c. Unemployment compensation received in excess of the employer's contributions is, in all cases, fully includable in the recipient's gross income for federal income tax purposes.
d. Payments made by a corporate employer for federal unemployment taxes are deductible as a business expense for federal income tax purposes.

M86#17. Farr, an employee of Sand Corp., was involved in an accident with Wohl, an independent contractor. Wohl was making a delivery for Byrd Corp. when Farr negligently passed through a red light resulting in the accident and injuries to Wohl and Farr. The accident occurred during Farr's regular working
hours and in the course of Farr's employment. If Sand and Byrd have complied with the state's workers' compensation laws, which of the following is correct?

a. Farr will either be denied workers' compensation benefits or have his benefits reduced due to his negligence.

b. Farr will be denied workers' compensation benefits since Sand was free from any wrongdoing.

c. Wohl will be denied workers' compensation benefits under Sand's or Byrd's workers' compensation policy.

d. Wohl will be denied workers' compensation benefits due to the fellow-servant rule.

**M85#18.** Which of the following statements is correct regarding social security benefits?

a. Retirement benefits paid in excess of the recipient's contributions will be included in the determination of the recipient's federal taxable income regardless of his gross income.

b. Upon the death of the recipient, immediate family members within certain age limits are entitled to a death benefit equal to the unpaid portion of the deceased recipient's contributions.

c. Retirement benefits are fully includable in the determination of the recipient's federal taxable income if his gross income exceeds certain maximum limitations.

d. Individuals who have made no contributions may be eligible for some benefits.

**M85#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.

**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.

**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#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.

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.

N84#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.

N83#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.

N83#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.

N83#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 respondeat 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.

N83#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.
Selected Questions

B. Federal Securities Acts

M87#39. Which of the following statements is correct with respect to the registration requirements of the Securities Exchange Act of 1934?

a. They require issuers of non-exempt securities traded on a national securities exchange to register with the SEC.

b. They permit issuers who comply with the Securities Act of 1933 to avoid the registration requirements of the Securities Exchange Act of 1934.

c. They permit issuers who comply with those requirements to avoid state registration requirements.

d. They permit issuers who comply with those requirements to avoid the registration requirements of the Securities Act of 1933.

M87#40. On May 1, Apel purchased 7% of Stork Corp.'s preferred stock which was traded on a national securities exchange. After the purchase Apel owned 9% of the outstanding preferred stock. Stork is registered under the Securities Exchange Act of 1934. With respect to the purchase, Apel

a. Is not required to file any report or information with the SEC since Apel owns less than 10% of the preferred stock.

b. Is required to file any report or information with the SEC since the security purchased was preferred stock.

c. Must file with the SEC, the issuer, and the national securities exchange information concerning the purpose of the acquisition.

d. Must file only with the SEC information concerning the source of the funds used to purchase the preferred stock.

M87#41. The registration requirements of the Securities Act of 1933 apply to

a. The issuance of a stock dividend without commissions or other consideration paid.

b. The issuance of stock warrants.

c. Securities issued by a federally chartered savings and loan association.

d. Securities issued by a common carrier regulated by the Interstate Commerce Commission.

M87#42. Which of the following persons is not an insider of a corporation subject to the Securities Exchange Act of 1934 registration and reporting requirements?

a. The president.

b. A member of the board of directors.

c. A shareholder who owns 8% of the outstanding common stock and whose wife owns 4% of the outstanding common stock.

d. An owner of 15% of the total face value of the corporation's outstanding debentures.

M87#43. Securities available under a private placement made pursuant to Regulation D of the Securities Act of 1933

a. Must be sold to less than 25 non-accredited investors.

b. Can not be the subject of an immediate re-offering to the public.

c. Can not be subject to the payment of commissions.

d. Must be sold to accredited institutional investors.

M87#44. Pate Corp. is offering $3 million of its securities solely to accredited investors pursuant to Regulation D of the Securities Act of 1933. Under Regulation D, Pate is

a. Not required to provide any specified information to the accredited investors.

b. Required to provide the accredited investors with audited financial statements for the two most recent fiscal years.

c. Permitted to make a general solicitation.

d. Not subject to the antifraud provisions of the federal securities laws.

M87#45. Regulation D of the Securities Act of 1933 is available to issuers without regard to the dollar amount of an offering only when the

a. Purchasers are all accredited investors.

b. Number of purchasers who are non-accredited is 35 or less.

c. Issuer is not a reporting company under the Securities Exchange Act of 1934.

d. Issuer is not an investment company.

M86#30. Which of the following is a security which is exempt from the registration requirements of the Securities Act of 1933?

a. Warrants to purchase preferred stock.

b. Convertible, subordinated debentures issued by a manufacturing company.

c. Common stock with a par value of less than $1.00.

d. Bonds issued by a charitable foundation.

M86#31. Under the Securities Act of 1933, the registration of securities which are offered to the public in interstate commerce is

a. Directed toward preventing the marketing of securities which pose serious financial risks to the prospective investor.

b. Not required unless the issuer is a corporation.

c. Mandatory unless the cost to the issuer is "prohibitive" as defined in the SEC regulations.

d. Required unless there is an applicable exemption.
Donn & Co. is considering the sale of $11 million of its common stock to the public in interstate commerce. In this connection, Donn has been correctly advised that registration of the securities with the SEC is

a. Not required if the states in which the securities are to be sold have securities acts modeled after the federal act and Donn files in those states.
b. Required in that it is necessary for the SEC to approve the merits of the securities offered.
c. Not required if the securities are to be sold through a registered brokerage firm.
d. Required and must include audited financial statements as an integral part of its registration.

Tulip Corp. is a registered and reporting corporation under the Securities Exchange Act of 1934. As such it

a. Can offer and sell its securities to the public without the necessity of registering its securities pursuant to the Securities Act of 1933.
b. Can not make a tender offer for the equity securities of another registered and reporting corporation without the consent of the SEC.
c. Must file annual reports (Form 10-K) with the SEC.
d. Must distribute a copy of the annual report (Form 10-K) to each of its shareholders.

One of the clients of Sherman & Pryor, CPAs, plans to form a limited partnership and offer to the public in interstate commerce 2,000 limited partnership units at $5,000 per unit. Which of the following is correct?

a. The dollar amount in question is sufficiently small so as to provide an absolute exemption from the Securities Act of 1933.
b. The Securities Act of 1933 requires a registration despite the fact that the client is not selling stock and the purchasers have limited liability.
c. Under the Securities Act of 1933, Sherman & Pryor has no responsibility for financial statements since the limited partnership is a new entity.
d. Sherman & Pryor may disclaim any liability under the federal securities acts by an unambiguous, bold-faced disclaimer of liability on its audit report.

The Securities Exchange Act of 1934

a. Applies exclusively to issuers whose securities are listed on an organized stock exchange.
b. Has no application to issuers who are not required to register.
c. Imposes additional requirements on those issuers who must register and report.
d. Requires registration and reporting by all issuers with $2 million or more of assets or which have 1,000 or more shareholders.

Which of the following facts will result in an offering of securities being exempt from registration under the Securities Act of 1933?

a. The securities are non-voting preferred stock.
b. The sale or offer to sell the securities is made by a person other than an issuer, underwriter or dealer.
c. The securities are AAA-rated debentures which are collateralized by first mortgages on property which has a value of 200% of the offering price.
d. The issuing corporation was closely held prior to the offering.

A primary purpose of the registration requirements of the Securities Act of 1933 is to

a. Ensure investors receive fair value for their investments.
b. Provide investors with information concerning a public offering of securities so that they can make informed investment decisions.
c. Detect and prevent a public offering of securities where management fraud and unethical conduct is suspected to be present.
d. Prevent the offering of securities considered to be unsound.

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 securities be purchased from an underwriter.
b. A registration statement has been filed.
c. The issuer or other defendants commit either negligence or fraud in the sale of the securities.
d. The plaintiff has acquired the securities in question.

Which of the following provisions of the Securities Exchange Act of 1934 applies despite the fact that a corporation's securities are exempt from registration?

a. The anti-fraud provisions.
b. The provisions dealing with the filing of periodic and annual reports.
c. The proxy provisions.
d. The provisions imposing internal accounting controls.

Regulation D under the Securities Act of 1933

a. Eliminates all small offerings made pursuant to Regulation A of the Securities Act of 1933.
b. Permits an exempt offering by a corporation even though it is a “reporting” corporation under the Securities Exchange Act of 1934.
c. Is limited to offers and sales of common stock which do not exceed $5 million.
d. Is exclusively available to “small business corporations” as defined by Regulation D.
Selected Questions

M86#23. Under the provisions of the Securities Exchange Act of 1934, corporations whose common stock is listed on a national stock exchange
   a. Must submit Form 10-K to the SEC except in those years in which the corporation has made a public offering.
   b. Must distribute copies of Form 10-K to its shareholders.
   c. Are subject to having the registration of their securities suspended or revoked.
   d. Are prohibited from making private placement offerings.

M86#24. Dee is the owner of 12% of the shares of common stock of D & M Corporation which she acquired in 1975. She is the treasurer and a director of D & M. The corporation registered its securities in 1984 and made a public offering pursuant to the Securities Act of 1933. If Dee decides to sell part of her holdings in D & M, the shares
   a. Would be exempt from registration since the corporation previously registered them within three years.
   b. Must be registered regardless of the amount sold or manner in which they are sold.
   c. Would be exempt from registration because she is not an issuer.
   d. Must be registered if Dee sells 50% of her shares through her broker to the public.

M86#25. Which of the following classes of securities or types of transactions are exempt from registration under the Securities Act of 1933?
   a. Transactions by any person other than an issuer, underwriter, or dealer.
   b. The sale of securities by a "control person."
   c. Non-voting, non-cumulative preferred stock.
   d. Collateralized bonds of public utilities.

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.

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#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.


Business Law

N84#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 min-
imum of $10,000 monetary damages.
c. Contain criminal sanctions against those who
come in fraudulent activities.
d. Contain remedies which are mutually exclu-
sive of each other.

N83#43. Although the Securities and Exchange Com-
mision has broad powers in conducting a formal in-
vestigative proceeding, the SEC can not
a. Impose monetary penalties without court pro-
cedings.

b. Compel a witness to appear.
c. Subpoena records.
d. Conduct its investigations secretly.

N83#44. The president of KK 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 Depart-
ment.
b. It is irrelevant whether the president had
knowledge of his wrongdoing in determin-
ning whether to impose a fine or prison term.
c. The SEC must elect between civil and crim-
inal action but may not pursue both.
d. A fine or prison term or both may be imposed.

VI. Uniform Commercial Code

A. Commercial Paper

N87#46. Which of the following on the face of an
otherwise negotiable instrument will affect the instru-
ment's negotiability?
a. The instrument is postdated.
b. The instrument is payable six months after
the death of the maker.
c. The instrument contains a promise to provide
additional collateral if there is a decrease in
tvalue of the existing collateral.
d. The instrument is payable at a definite time
subject to an acceleration clause in the event
of a default.

N86#40. Dart induces Shorr by fraud to make a prom-
issory note payable to Dart. Dart negotiates the note
for value to Best, who was aware of the fraud. Best
negotiates the note to Case, a holder in due course.
Subsequently, Best repurchases the note from Case.
Which of the following statements is correct?
a. Best does not succeed to Case's rights as a
holder in due course.
b. Best becomes a holder in due course upon
taking the note from Dart.
c. Because of the fraud by Dart, the note is non-
negotiable.
d. Best's knowledge of Dart's fraud is immaterial in
determining Best's status as a holder in
due course.

N86#41. Hand executed and delivered to Rex a $1,000
negotiable note payable to Rex or bearer. Rex then
negotiated it to Ford and endorsed it on the back by
merely signing his name. Which of the following is a
correct statement?
a. Rex's endorsement was a special endorse-
ment.
b. Rex's endorsement was necessary to Ford's
qualification as a holder.
c. The instrument initially being bearer paper
can not be converted to order paper.
d. The instrument is bearer paper and Ford can
convert it to order paper by writing "pay to
the order of Ford" above Rex's signature.

N86#42. To the extent that a holder of a negotiable
promissory note is a holder in due course, he takes
the note free from which of the following defenses?
a. Minority of the maker where it is a defense
to enforcement of a contract.
b. Forgery of the maker's signature.
d. Discharge of the maker in bankruptcy.

N86#43. Which of the following prevents an instru-
ment from being negotiable?
a. An endorsement on the back of the instru-
ment which reads: "Pay Smith only."
b. An instrument which is payable after com-
pletion of a contractual obligation which is
certain to happen but uncertain as to the time
of occurrence.
c. The fact that it is unclear whether the instru-
ment is intended to be a note or a draft.
d. The capacity in which the party signed was
unclear.

B-38
Selected Questions

M86#44. Your client has in its possession the following instrument:

<table>
<thead>
<tr>
<th>No. 1625</th>
</tr>
</thead>
<tbody>
<tr>
<td>FAIR FOOD WHOLESALERS, INC.</td>
</tr>
<tr>
<td>22 Woodrow Wilson Hayes Lane</td>
</tr>
<tr>
<td>Columbus, Ohio</td>
</tr>
</tbody>
</table>

Jan. 10, 1986

On demand the undersigned promises to pay to

Bearer $1,200.00

Twelve hundred & ten/100's Dollars

Fair Food Wholesalers, Inc.

By James Duff, President

For: _____________

The instrument is

a. A non-negotiable promissory note.
b. Non-negotiable because the instrument is incomplete.
c. A negotiable time draft.
d. Negotiable despite the inconsistency between the amount in words and the amount in numbers.

M86#28. Frank Supply Co. held the following instrument:

| Clark Novelties, Inc. |
| April 12, 1986 |
| 29 State Street |
| Spokane, Washington |

Pay to the order of Frank Supply Co. on April 30, 1986 ten thousand and 00/100 dollars ($10,000.00).

Smith Industries, Inc.

By Mitchell Clark

Mitchell Clark, President

Date: April 20, 1986

As a result of an audit examination of this instrument which was properly endorsed by Frank to your client, it may be correctly concluded that

a. Smith was primarily liable on the instrument prior to acceptance.
b. The instrument is non-negotiable and thus no one has rights under the instrument.
c. No one was primarily liable on the instrument at the time of issue, April 12, 1986.
d. Upon acceptance, Clark Novelties, Inc. became primarily liable and Smith was released from all liability.

M86#26. An instrument reads as follows:

| Pay April 1, 1986 |
| to the Order of Donald Kent, Fifteen days after date, $100.00 |
| One hundred and no/100 Dollars |
| Union Corp. Ridgefield, Connecticut Dale Cox |
| re: down payment on auto purchase |

The instrument

a. Is non-negotiable since it incorporates the auto purchase transaction by reference.
b. Is a negotiable time draft.
c. Is a negotiable sight draft.
d. Is a non-negotiable trade acceptance.

M86#30. The UCC Article on Commercial Paper requires that an instrument, to be negotiable, must “contain an unconditional promise or order to pay...” The requirement is met by which of the following?

a. “I hereby acknowledge my debt to the payee.”
b. “I hereby assign all my rights to collect all monies due on the instrument.”
c. “Pay to bearer” contained in a draft.
d. An endorsement which reads “pay to the order of...”

M86#30. Karr transferred a negotiable instrument payable to his order to Watson for value. Karr did not endorse the instrument. As a result of the transfer, Watson

a. Obtains such rights as the transferor had in all cases.
b. Can become a holder only if the instrument is endorsed and delivered at the same time.
c. Is presumed to be the owner of the instrument since he gave value.
d. Is entitled to an unqualified endorsement by Karr.
The status of a holder in due course as opposed to a mere holder of a negotiable instrument
a. Is of little consequence as a practical matter.
b. Eliminates the necessity of making due presentment or giving notice of dishonor.
c. Allows the holder in due course to overcome certain defenses that can not be overcome by a mere holder.
d. Allows the further negotiation of the instrument.

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.

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.

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.

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.

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.

Ted Green

This note is
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.

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.
Selected Questions

N85#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 a(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.

N85#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.

N85#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.

N85#33. The following instrument was received by Kerr:

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 filing-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.

$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 conditions.
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.
President

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 conditions.
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.
President

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 conditions.
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.
President

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 conditions.
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.
President

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 conditions.
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.
President

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 conditions.
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.
President

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 conditions.
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.
President

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 conditions.
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.
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#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.

**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#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.

**M84#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>
<thead>
<tr>
<th>No. 121</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct. 3, 1984</td>
</tr>
<tr>
<td>51-109</td>
</tr>
<tr>
<td>332</td>
</tr>
<tr>
<td>Pay to the order of Sinka Corp.</td>
</tr>
<tr>
<td>Two Thousand Five Hundred and 00/100 Dollars</td>
</tr>
<tr>
<td>Fifteen days after presentment</td>
</tr>
<tr>
<td>Bocca Trust Company</td>
</tr>
<tr>
<td>Portland, Oregon</td>
</tr>
<tr>
<td>Memo: For purchase of stock</td>
</tr>
</tbody>
</table>

The above instrument is

a. A draft.
b. Nonnegotiable.
c. A check.
d. A trade acceptance.

**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 read 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.
Selected Questions

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.

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.

48#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.

B. Documents of Title and Investment Securities

M85#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.

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.

M83#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.
Selected Questions

M83#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 mis-description 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 possessor 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
a. A registered negotiable investment security which Dwight took free of adverse title claims.
b. Nonnegotiable, since the instrument must be registered with Magnum to be validly transferred.
c. Negotiable commercial paper.
d. A nonnegotiable investment security, since the instrument lacks the words of negotiability, “to the order of or bearer.”

C. Sales

M87#48. Under the UCC Sales Article, the warranty of title may be excluded
a. By the seller’s statement that she is selling only such right or title that she has.
b. By the seller’s statement that the goods are being sold with all faults.
c. Only in a writing signed by the seller.
d. Only by a non-merchant seller.

M87#49. Which of the following factors will be most important in determining if an express warranty has been created?
a. Whether the statements made by the seller were in writing.
b. Whether the seller intended to create a warranty.
c. Whether the promises made by the seller became part of the basis of the bargain.
d. Whether the sale was made by a merchant in the regular course of business.

M87#50. Under the UCC, an action for breach of the implied warranty of merchantability by a party who sustained personal injuries may be successful against the seller of the product only when
a. The injured party is in privity of contract with the seller.
b. The seller is a merchant with respect to the product involved.
c. An action based on strict liability in tort can also be successfully maintained.
d. An action based on negligence can also be successfully maintained.
M87#51. Wink ordered 80 #5 ovens at list price from Dunn Wholesaler. Immediately upon receipt of Wink's order, Dunn sent Wink an acceptance which was received by Wink. The acceptance indicated that shipment would be made within seven days. On the seventh day Dunn discovered that all of its supply of #5 ovens had been sold. Instead it shipped 80 #7 ovens, stating clearly on the invoice that the shipment was sent only as an accommodation. Which of the following is correct?

a. Wink's order is a unilateral offer, and can only be accepted by Dunn's shipment of the goods ordered.
b. Dunn's shipment of #7 ovens is a counter-offer, thus no contract exists between Wink and Dunn.
c. Dunn's shipment of #7 ovens constitutes a breach of contract.
d. Dunn's note of accommodation cancels the contract between Dunn and Wink.

c. Bold must deliver the computers to Anker on credit since Anker has not breached the contract.
d. Bold must deliver the computers to Anker since the risk of loss had passed to Anker.

M87#54. If a contract for the sale of goods includes a C. & F. shipping term and the seller has fulfilled all of its obligations, the

a. Title to the goods will pass to the buyer when the goods are received by the buyer at the place of destination.
b. Risk of loss will pass to the buyer upon delivery of the goods to the carrier.
c. Buyer retains the right to inspect the goods prior to making payment.
d. Seller must obtain an insurance policy at its own expense for the buyer's benefit.

M87#55. Which of the following is most important in determining who bears the risk of loss in a sale of goods contract?

a. The shipping terms.
b. The agreement of the parties.
c. Who has title to the goods.
d. Who has possession of the goods.

M87#56. Which of the following is necessary in order for the warranty of merchantability to arise where there has been a sale of goods?

I. The seller must be a merchant with respect to goods of that kind.
II. The warranty must be in writing.
III. The buyer must have relied on the seller's skill or judgment in selecting the goods.

a. I only.
b. I, II, and III.
c. I and III only.
d. II and III only.

M86#46. Kent suffered an injury due to a malfunction of a chain saw he had purchased from Grey Hardware. The saw was manufactured by Dill Tool Corp. Kent has commenced an action against Grey and Dill based upon strict liability. Which of the following is a correct statement?

a. Dill will not be liable if it manufactured the saw in a nonnegligent manner.
b. Privity will not be a valid defense against Kent's suit.
c. The lawsuit will be dismissed since strict liability has not been applied in product liability cases in the majority of jurisdictions.
d. Kent's suit against Grey will be dismissed since Grey was not at fault.
**Selected Questions**

**N86#47.** Greed Co. telephoned Stieb Co. and ordered 30 tables at $100 each. Greed agreed to pay 15% immediately and the balance within thirty days after receipt of the entire shipment. Greed forwarded a check for $450 and Stieb shipped 15 tables the next day, intending to ship the balance by the end of the week. Greed decided that the contract was a bad bargain and repudiated it, asserting the statute of frauds. Stieb sued Greed. Which of the following will allow Stieb to enforce the contract in its entirety despite the statute of frauds?

a. Stieb shipped 15 tables.

b. Greed paid 15% down.

c. The contract is not within the requirements of the statute of frauds.

d. Greed admitted in court that it made the contract in question.

**N86#33.** Tint is suing the manufacturer, the wholesaler, and the retailer for bodily injuries caused by a snowblower Tint purchased. Under the theory of strict liability

a. Contributory negligence on Tint's part will always be a bar to recovery.

b. Privity will be a bar insofar as the wholesaler is concerned if the wholesaler did not have a reasonable opportunity to inspect.

c. Tint may recover despite the fact that he can not show that any negligence involved.

d. The manufacturer will avoid liability if it can show it followed the custom of the industry.

**N86#34.** The UCC Sales Article applies

a. To a contract for personal services.

b. To the sale of patents.

c. To the sale of goods only if the buyer and seller are merchants.

d. To the sale of specially manufactured goods.

**N85#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.

**N85#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.

**N85#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.

**N85#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.

**N85#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 unequivocally 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.
**Business Law**

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.

N84#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.

N84#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.

N84#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 reopens the bidding.

N84#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.

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.

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 Statute 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 contained 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 sent a telegram which arrived on October 6, and accepted the offer expressly subject to a change of the payment terms to 2/10, net/30. Baker phoned Clark on October 7, rejecting the change of payment terms. Clark then indicated it would accept the October 1 offer in all respects, and expected delivery within 10 days. 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. 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#56. 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#57. 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.

M83#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.

M83#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.

M83#40. 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 anticipatory repudiation.
   b. Will prevent Nugent from retracting its repudiation 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.

D. Secured Transactions

M87#56. On March 1, Dun purchased $50,000 of equipment from Lux Corp. for use in Dun’s manufacturing process. Dun paid for the equipment with funds borrowed from Best Bank that same day. Dun executed a security agreement and financing statement covering Dun’s existing and after-acquired equipment. On March 7, Dun was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code and a trustee in bankruptcy was appointed. On March 9, Best properly filed the financing statement. Which of the parties will have a superior security interest in the equipment?
   a. Best, because it perfected its security interest within the permissible time limits.
   b. Best, because it had a perfected purchase money security interest without having to file a financing statement.
   c. The trustee in bankruptcy because the trustee became a lien creditor prior to the time Best perfected its security interest.
   d. The trustee in bankruptcy because the filing of the financing statement after the commencement of the bankruptcy case would be deemed a preferential transfer.
Selected Questions

M87#58. Which of the following requirements is not necessary in order to have a security interest attach?
   a. There must be a proper filing.
   b. Value must be given by the creditor.
   c. Either the creditor must take possession or the debtor must sign a security agreement that describes the collateral.
   d. The debtor must have rights in the collateral.

M87#59. If a manufacturer assigns 90% of its accounts receivable to a factor, perfection will occur by

<table>
<thead>
<tr>
<th>Filing a financing statement</th>
<th>Possession</th>
<th>Attachment</th>
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<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
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<td>b.</td>
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<td>c.</td>
<td>No</td>
<td>No</td>
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<tr>
<td>d.</td>
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M87#60. On May 4, Tint, a computer wholesaler, purchased 30 computers. This comprised Tint’s entire inventory and was financed under an agreement with Dome Bank which gave the bank a security interest in all computers on the premises, all future acquired computers, and the proceeds of sales. On May 8, Dome filed a financing statement that adequately identified the collateral. On June 9, Tint sold one computer to Bean for personal use and four computers to Green Co. for its business. Which of the following is correct?
   a. The computer sold to Bean will not be subject to Dome’s security interest.
   b. The computers sold to Green will be subject to Dome’s security interest.
   c. The security interest does not include the proceeds from the sale of the computers to Green.
   d. The security interest may not cover after-acquired property even if the parties agree.

M86#49. Under the UCC, which of the following is correct regarding the disposition of collateral by a secured creditor after the debtor’s default?
   a. It is improper for the secured creditor to purchase the collateral at a public sale.
   b. The collateral must be disposed of at a public sale.
   c. A good faith purchaser for value and without knowledge of any defects in the sale takes free of any subordinate liens or security interests.
   d. Secured creditors with subordinate claims retain the right to redeem the collateral after the disposition of the collateral to a third party.

M86#50. The perfection of a security interest by filing a financing statement
   a. Serves to protect the secured party’s interest in the collateral against most creditors who acquire a security interest in the same collateral after the filing.
   b. Is necessary to enable the secured party to enforce its security interest against the debtor.
   c. Serves to give the public actual notice.
   d. Gives the secured party priority over all other parties who acquire an interest in the collateral after the filing.

M86#52. In order for a security interest in goods to attach, the
   a. Debtor must sign a security agreement which adequately describes the goods.
   b. Debtor must retain possession of the goods until the underlying debt has been satisfied.
   c. Creditor must properly file a financing statement.
   d. Creditor must have given value.

M86#37. Wills, engaged in the business of selling appliances, borrowed $5,000 from Hart on January 20, 1986. Wills executed a promissory note for that amount and pledged all of his customer installment receivables as collateral for the loan. Wills executed a security agreement which described the collateral, but Hart did not file a financing statement. With respect to this transaction
   a. The UCC Article on Secured Transactions does not apply because Hart failed to file a financing statement.
   b. Attachment of the security interest did not occur because Hart failed to file a financing statement.
   c. Attachment of the security interest took place when Wills executed the security agreement.
   d. Perfection of the security interest occurred despite Hart’s failure to file a financing statement.

M86#38. The UCC establishes the rights of a secured creditor of a merchant in relation to various types of third parties. Regarding these third parties, which of the following is most likely to have an interest superior to that of a secured party who has a prior perfected security interest?
   a. Purchasers from the merchant in the ordinary course of business.
   b. General creditors of the merchant.
   c. Lien creditors of the merchant.
   d. Trustee in bankruptcy.

M86#39. Cross has an unperfected security interest in the inventory of Safe, Inc. The unperfected security interest
   a. Is superior to the interest of subsequent lenders who obtain a perfected security interest in the property.
   b. Is subordinate to lien creditors of Safe who become such prior to any subsequent perfection by Cross.
   c. Causes Cross to lose important rights against Safe as an entity.
   d. May only be perfected by Cross filing a financing statement.
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.

46. 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.

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.
   c. May retain possession of the stereo, thereby discharging Foxx of any deficiency.
   d. May retain possession of the stereo and collect any deficiency plus costs from Foxx.

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.
Selected Questions

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 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.

M84#57. Pine has a security interest in certain goods purchased by Byron on an installment contract. Byron has defaulted on the payments resulting in Pine’s taking possession of the collateral. Which of the following is correct?
a. Byron may waive his right of redemption at the time he executes the security agreement.
b. Pine must sell the collateral if Byron has paid more than 60% of the cash price on a purchase money security interest in business equipment.
c. The collateral may be sold by Pine at a private sale and, if the collateral is consumer goods, without notice to other secured parties.
d. Unless otherwise agreed, Pine must pay Byron for any increase in value of the collateral while the collateral is in Pine’s possession.

M84#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.

M84#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 manufacturers 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 in question 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#57. Rich Electronics sells various brand name television and stereo sets at discount prices. Rich maintains a large inventory which it obtains from various manufacturers on credit. These manufacturer-creditors have all filed and taken security interests in the goods and proceeds therefrom which they have sold to Rich on credit. Rich in turn sells to hundreds of ultimate consumers; some pay cash but most buy on credit. Rich takes a security interest but does not file a financing statement for credit sales. Which of the following is correct?

a. Since Rich takes a purchase money security interest in the consumer goods sold, its security interest is perfected upon attachment.
b. The appliance manufacturers can enforce their security interests against the goods in the hands of the purchasers who paid cash for them.
c. A subsequent sale by one of Rich's customers to a bona fide purchaser will be subject to Rich's security interest.
d. The goods in Rich's hands are consumer goods.

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.

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#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 note 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.
A. Real and Personal Property

N86
Items 56 and 57 are based on the following information:

On July 1, 1986, A, B, C, and D purchased a parcel of land as tenants in common each owning an equal share. On July 10, A died leaving a will. Subsequently, B died intestate.

56. After A and B's death,
   a. C and D will each own a 1/2 interest in the land.
   b. C and D will each own a 1/4 interest in the land.
   c. C and D will each own a 1/3 interest in the land.
   d. The tenancy in common will terminate.

57. If C sells her interest in the land to X,
   a. The tenancy in common will terminate.
   b. D and X will each own a 1/2 interest in the land.
   c. D and X will each own a 1/3 interest in the land.
   d. D and X will each own a 1/4 interest in the land.

M86#41. Mack & Watts, CPAs, wishes to relocate its office. Its existing lease is for four years, with one year remaining. Its landlord is not agreeable to canceling the lease. The lease also prohibits a sublease without the landlord's consent but is silent as to an assignment. Mack & Watts has found a financially responsible and respectable prospective subtenant but is convinced that the landlord will not consent to a sublease. Which of the following statements is correct?
   a. A sublease without the landlord's consent would not be a breach of the lease.
   b. An assignment by Mack & Watts would be a breach of the lease.
   c. An assignment by Mack & Watts would not relieve it of liability under the lease.
   d. A sublease with the landlord's consent would relieve Mack & Watts of liability under the lease.

M86#42. In order for a deed to be effective between the purchaser and seller of real estate, the deed must be
   a. Delivered by the seller with an intent to transfer title.
   b. Recorded within the permissible statutory time limits.
   c. In writing and signed by the seller and purchaser.
   d. Essentially in the same form as the contract for purchase and sale and include the actual sales price.

N86#58. Which of the following warranty (warranties) is (are) given by a general warranty deed?
   I. The grantor owns the property being conveyed.
   II. The grantee will not be disturbed in her possession of the property by the grantor or some third party's lawful claim of ownership.
   III. The grantor has the right to convey the property.

   a. I only.
   b. I, II, and III.
   c. I and III only.
   d. II and III only.

B-55
months. Frey has an option to purchase the ten lathes for $200 upon completion of the 60 payments. Tri has accounted for this lease as a sales-type lease and Frey has accounted for this lease as a capital lease. Assuming Frey exercises the option, which of the following statements is correct?
   a. Frey lacks an insurable interest in the lathes until it exercises the option to purchase them.
   b. The lease agreement represents a purchase money security interest which is automatically perfected without the necessity of filing a financing statement.
   c. In order to have an enforceable lease Tri must file a security agreement.
   d. Title to the lathes passed to Frey prior to the time Frey exercised the option.

M85#46. Dash has agreed to sell a warehouse for $300,000 to Bosch. The contract provided that Dash will convey to Bosch whatever interest Dash may have in the warehouse. Under the terms of the contract, Bosch is entitled to receive a/an:
   a. Insurable deed.
   b. Quitclaim deed.
   c. General warranty deed.
   d. Special warranty deed.

N85

Items 51 and 52 are based on the following information:

Mini, Inc., entered into a five-year lease with Rein Realtors. The lease was signed by both parties and immediately recorded. The leased building was to be used by Mini in connection with its business operations. To make it suitable for that purpose, Mini attached a piece of equipment to the wall of the building.

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.

N85#53. Jane and her brother each own a 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.

N85#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.

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 Noll’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.

B-56
Selected Questions

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 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.

B. Mortgages

N86#53. Which of the following statements is correct with respect to a real estate mortgage?
   a. It must be signed only by the mortgagor (borrower).
   b. It must be recorded in order to be effective between the mortgagor and mortgagee.
   c. It does not have to be recorded to be effective against third parties without notice if it is a purchase money mortgage.
   d. It is effective even if not delivered to the mortgagee.

N86#54. Watts gave a mortgage on a vacant lot to Fast to secure payment of a note. Fast assigned the note and mortgage to Beal who paid 85% of the face value for it. Neither Fast nor Beal recorded the mortgage. Subsequently, Fast assigned the same note and mortgage to Rusk who paid 75% of the face value for it and who had no notice of the prior assignment to Beal. Rusk promptly recorded the mortgage and the assignment. Watts has made no payments on the note. The jurisdiction has a notice-type of recordation statute. Under the circumstances
   a. The assignments to Beal and Rusk are ineffective because Fast failed to record the mortgage.
   b. Equity will require that Beal and Rusk share in the proceeds of the note equally as their interests may appear.
   c. Rusk is entitled to recover only 75% of the face value of the note.
   d. Rusk is entitled to the full face amount of the Watts note.

N86#55. In a notice-type recordation jurisdiction, failure by the mortgagee to record its mortgage
   a. Releases the mortgagor (borrower) from the underlying obligation to pay.
   b. Permits a subsequent mortgagee without knowledge of the prior mortgage to have a superior security interest.
   c. Permits a subsequent purchaser for value with knowledge of the mortgage to take the property free of the prior security interest.
   d. Permits a subsequent mortgagee with knowledge of the prior mortgage to have a superior security interest provided he promptly records his mortgage.

M86#47. Which of the following statements pertaining to a mortgage on a building is incorrect?
   a. The mortgagor customarily retains legal title to the building despite the mortgage.
   b. The recording of the mortgage is necessary to validate the rights and liabilities of the mortgagor and mortgagee against each other.
   c. The mortgage must be in writing and signed by the mortgagor.
   d. The mortgage must contain a description of the property subject to the mortgage.

M86#48. Which of the following statements regarding the recording of a real estate mortgage in a state having a notice-race statute is correct?
   a. By recording, the mortgagee will acquire additional rights against the mortgagor.
   b. The mortgagee must file a financing statement with the appropriate state agency.
   c. The recording of a mortgage is necessary to defeat the claims of a purchaser for value who had knowledge of the mortgage.
   d. The recording of the mortgage will be important in determining priority among parties who claim an interest in the real estate.

M86#49. Glenn borrowed $80,000 from City Bank. He executed a promissory note and secured the loan with a mortgage on business real estate he owned as a sole proprietor. Glenn neglected to advise City that he had previously mortgaged the property to Ball, who
had failed to record his mortgage. City promptly recorded its mortgage. Subsequently, Glenn conveyed his business assets including the property to a newly created corporation in exchange for all of its stock. Which of the following is correct?
   a. Ball’s mortgage is prior in time and would take priority over City’s mortgage
   b. Glenn’s corporation will take the property subject to both mortgages.
   c. The corporation will be deemed to have assumed both mortgages.
   d. On foreclosure, Glenn could not be called upon to pay City any 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 possessor security interest in State.
   d. Generally does not affect the rights of Farr and State against each other under the promissory note.

55 and 56 are based on the following information:

On June 1, 1985, Byrd Corp. purchased a high-rise building from Slade Corp. for $375,000. The building was encumbered by a mortgage and note dated May 1, 1980 executed by Slade. The mortgage had been duly recorded by the mortgagor, Fale Bank. The outstanding balance on the mortgage at the time of Byrd’s purchase was $300,000. Byrd acquired the property subject to the mortgage held by Fale and, in addition, gave a mortgage on the building to Foxx Finance to secure a non-purchase money promissory note in the sum of $50,000. Prior to any payments being made on either loan, Byrd defaulted. As a result, the building was properly sold at a foreclosure sale for $280,000.

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.

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   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.
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   d. Generally does not affect the rights of Farr and State against each other under the promissory note.
Selected Questions

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.

C. Fire and Casualty Insurance

N86#59. The earliest time a purchaser of existing goods will acquire an insurable interest in those goods is when
   a. The purchaser obtains possession.
   b. Title passes to the purchaser.
   c. Performance of the contract has been completed or substantially completed.
   d. The goods are identified to the contract.

N86#60. Long Co. owns a warehouse which is insured in the amount of $60,000 against loss by fire. The policy contains an 80% coinsurance clause. A fire totally destroyed the warehouse which was valued at the time of the loss at $150,000. Long is entitled to receive
   a. $0, since it failed to meet the coinsurance requirements.
   b. $48,000.
   c. $60,000.
   d. $75,000.

N85#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.

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.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. The CPA and the Law

A. Common Law

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B. Federal Statutory

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C. Workpapers, Privileged Communication, and Confidentiality

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II. Business Organizations

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B. Partnerships and Joint Ventures

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C. Corporations

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III. Contracts

A. Offer and Acceptance

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B. Consideration

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### IV. Debtor-Creditor Relationships

#### A. Suretyship

| M84#21 c | M87#32 b | N84#26 c |
| M87#26 a | M84#22 d | N84#27 b |
| M87#27 b | M84#23 c | N84#28 d |
| M87#28 c | M84#24 c | M84#16 b |
| M87#29 a | M83#25 c | M84#18 a |
| N86#26 b | M83#26 c | M85#24 d |
| N86#27 a | M83#27 a | M85#27 d |
| N86#28 c | N85#28 b | M83#22 d |

#### B. Bankruptcy

| N85#31 c | M87#30 b | N85#30 a |
| N85#32 b | M87#31 c | M83#24 d |

### V. Government Regulation of Business

#### A. Regulation of Employment

| M85#31 c | M87#41 b | M86#21 a |
| N84#37 b | M87#42 d | M86#22 b |
| N84#39 c | M87#43 b | M86#23 c |
| M87#36 c | M84#40 c | M86#24 d |
| M87#37 a | M84#44 a | M86#25 a |
| M87#38 b | M84#45 b | M84#14 a |
| N86#37 c | N86#39 b | N85#6 c |
| N86#38 c | N86#41 d | M85#22 c |
| N86#39 a | M83#34 c | M85#24 c |
| M86#16 d | M86#33 c | M84#45 b |
| M86#17 c | N86#34 b | M84#30 c |

#### B. Federal Securities Acts

| N86#35 c | M84#33 a | N84#33 c |
| N86#18 d | M86#36 b | M84#34 c |
| N85#21 d | M86#19 b | N83#43 a |
| N85#22 c | M87#39 a | M86#14 a |
| M85#30 d | M86#40 c | N83#44 d |
Unofficial Answers

VI. Uniform Commercial Code

A. Commercial Paper

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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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ESSAYS — SELECTED QUESTIONS

I. The CPA and the Law

M67
Number 3 (Estimated time — 15 to 20 minutes)

Dill Corp. was one of three major suppliers who sold raw materials to Fogg & Co. on credit. Dill became concerned over Fogg's ability to pay its debts. Payments had been consistently late and some checks had been returned, marked "insufficient funds". In addition, there were rumors concerning Fogg's solvency. Dill decided it would make no further sales to Fogg on credit unless it received a copy of Fogg's current, audited financial statements. It also required Fogg to assign its accounts receivable to Dill to provide security for the sales to Fogg on credit.

Clark & Wall, CPAs, was engaged by Fogg to perform an examination of Fogg's financial statements upon which they subsequently issued an unqualified opinion. Several months later, Fogg defaulted on its obligations to Dill. At this point Dill was owed $240,000 by Fogg. Subsequently, Dill discovered that only $60,000 of the accounts receivable that Fogg had assigned to Dill as collateral was collectible.

Dill has commenced a lawsuit against Clark & Wall. The complaint alleges that Dill has incurred a $180,000 loss as a result of negligent or fraudulent misrepresentations contained in the audited financial statements of Fogg. Specifically, it alleges negligence, gross negligence, and actual and/or constructive fraud on the part of Clark & Wall in the conduct of the audit and the issuance of an unqualified opinion.

State law applicable to this action follows the majority rule with respect to the accountant's liability to third parties for negligence. In addition, there is no applicable state statute which creates an accountant-client privilege. Dill demanded to be provided a copy of the Fogg workpapers from Clark & Wall who refused to comply with the request claiming that they are privileged documents. Clark & Wall has asserted that the entire action should be dismissed because Dill has no standing to sue the firm because of the absence of any contractual relationship with it, i.e., a lack of privity.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Will Clark & Wall be able to avoid production of the Fogg workpapers based upon the assertion that they represent privileged communications?

b. What elements must be established by Dill to show negligence on the part of Clark & Wall?

c. What is the significance of compliance with GAAS in determining whether the audit was performed negligently?

d. What elements must be established by Dill to show actual or constructive fraud on the part of Clark & Wall?

M66
Number 2 (Estimated time — 15 to 20 minutes)

Tyler Corp. is insolvent. It has defaulted on the payment of its debts and does not have assets sufficient to satisfy its unsecured creditors. Slade, a supplier of raw materials, is Tyler's largest unsecured creditor and is suing Tyler's auditors, Field & Co., CPAs. Slade had extended $2 million of credit to Tyler based on the strength of Tyler's audited financial statements. Slade's complaint alleges that the auditors were either (1) negligent in failing to discover and disclose fictitious accounts receivable created by management or (2) committed fraud in connection therewith. Field believes that the financial statements of Tyler were prepared in accordance with GAAP and, therefore, its opinion was proper. Slade has established that:

- The accounts receivable were overstated by $10 million.
- Total assets were reported as $24 million of which accounts receivable were $16 million.
- The auditors did not follow their own audit program which required that confirmation requests be sent to an audit sample representing 80% of the total dollar amount of outstanding receivables. Confirmation requests were sent to only 45%.
- The responses which were received represented only 20% of the total dollar amount of outstanding receivables. This was the poorest response in the history of the firm, the next lowest being 60%. The manager in charge of the engagement concluded that further inquiry was necessary. This recommendation was rejected by the partner in charge.
Business Law

Field had determined that a $300,000 account receivable from Dion Corp. was non-existent. Tyler's explanation was that Dion had reneged on a purchase contract before any products had been shipped. At Field's request Tyler made a reversing entry to eliminate this overstatement. However, Field accepted Tyler's explanation as to this and several similar discrepancies without further inquiry.

Slade asserts that Field is liable:

- As a result of negligence in conducting the audit.
- As a result of fraud in conducting the audit.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

Discuss Slade's assertions and the defenses which might be raised by Field.

**M85**

**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.

- 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?

- What is the duty of the CPA in the event suspicious circumstances are revealed as a result of the review?

- What potential liability does Mason & Dilworth face and who may assert claims against the firm?

**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:
  - The federal securities acts.
  - State common law.

**M84**

**Number 2 (Estimated time — — 15 to 20 minutes)**

Perfect Products Co. applied for a substantial bank loan from Capitol City Bank. In connection with its application, Perfect engaged William & Co., CPAs, to audit its financial statements. William completed the audit and rendered an unqualified opinion. On the basis of the financial statements and William's opinion, Capitol granted Perfect a loan of $500,000.

Within three months after the loan was granted, Perfect filed for bankruptcy. Capitol promptly brought
suit against William for damages, claiming that it had relied to its detriment on misleading financial statements and the unqualified opinion of William.

William's audit workpapers reveal negligence and possible other misconduct in the performance of the audit. Nevertheless, William believes it can defend against liability to Capitol based on the privity defense.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

1. Explain the privity defense and evaluate its application to William.
2. What exceptions to the privity defense might Capitol argue?

**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.

**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?

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**II. Business Organizations**

**B. Partnerships and Joint Ventures**

**N86**

**Number 2 (Estimated time — 15 to 20 minutes)**

Edna Slavin intends to enter into a limited partnership with three of her business associates. Slavin wishes to know the advantages and disadvantages of being a general partner as opposed to a limited partner in a limited partnership. The issues of most concern to Slavin are:

- Her right as a general or limited partner to participate in the daily management of the partnership.
- Her liability as a general or limited partner for debts incurred on behalf of or by the partnership.
- Her right as a general or limited partner to assign her partnership interest and substitute a third party as a partner.
- The effect of a clause in the certificate of limited partnership which would permit the partnership to continue after the death of one of the general or limited partners.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What are the essential differences in the formation of a general partnership and a limited partnership? Discuss in separate paragraphs the issues raised by Slavin.

**N85**

**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.

**M84**

**Number 5**

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.

**C. Corporations**

**N86**

**Number 4 (Estimated time — 15 to 20 minutes)**

Jane Mead, a 7% minority shareholder in Sky Corp. for several years, is unhappy with the way Ed Rice, the president of Sky, has been operating Sky. The Board of Directors of Sky has refused to pursue any of the actions requested by Mead. In addition, Sky is contemplating a proposed merger with King Corp., a conglomerate into which Sky would be merged.

As a result of the foregoing, Mead asserts that she personally has the right to:

- Examine the books, records, and shareholder list of Sky.
- Have Rice removed as president of Sky.
- Obtain payment for her shares in Sky in the event the proposed merger is consummated.

Rice refuses to give Mead access to Sky’s books, records, and shareholder list and asserts the following:

- That the refusal to permit Mead access to Sky’s books, records, and shareholder list is based upon Mead’s attempt to sell the shareholder list 13 months ago.
- That he cannot be removed as president of Sky since he has a three-year written contract with two years remaining, and that such removal can only be made for cause by a majority vote of the shareholders at its annual meeting.
- That Mead would not be entitled to payment in the event the merger is consummated since the Articles of Incorporation are silent on this point.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

a. Discuss the assertions of Mead and Rice with regard to Mead’s right to inspect Sky’s books, records, and shareholder list.

b. Discuss the assertions of Mead and Rice with regard to whether Rice may be removed as the president of Sky.

c. Discuss the assertions of Mead and Rice with regard to whether Mead is entitled to payment for her shares in the event the merger is consummated.

**M86**

**Number 4 (Estimated time — 15 to 20 minutes)**

Major formed the Dix Corp. for the purpose of operating a business to repair, install, and sell used refrigerators. Major is the sole shareholder and president of Dix. Major owns 2,000 shares of $10 par value common stock. He paid for 1,000 of these shares by transferring to Dix property with a fair market value of $3,500 and his promissory note for $2,500 due and payable on June 1, 1988. He also received at a later date 1,000 shares in consideration of services rendered to Dix fairly valued at $7,000 and his agreement to render specific additional services starting with January 1, 1987 which are fairly valued at $1,000. The promissory note has not been paid nor have the additional services been rendered.
Selected Questions

Fox, a customer of Dix, was seriously injured when a refrigerator negligently repaired by Major on behalf of Dix caught fire. Dix has $500,000 of liability insurance covering itself and its employees for such occurrences. Fox wishes to hold Major personally liable since Dix has insufficient assets and insurance to pay Fox's claim.

Pine, one of Dix's largest creditors, has asserted claims against Major, individually, claiming that Major is:

- Personally liable to the extent of $6,000 for the common shares issued to him.
- Personally liable for all of the debts of Dix because he instructed several of Dix's customers to make checks payable to the order of Major which were deposited in his individual account and not recorded on the corporate books.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss Major's liability and the liability of Dix for the injuries sustained by Fox. What effect does the insurance carried by Dix have on Major's and Dix's liability to Fox?

b. Discuss the assertions of Pine and reach a conclusion for each.

N84

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 operations. 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.
Business Law

- 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.

D. Estates and Trusts

M87

Number 5 (Estimated time — — 15 to 20 minutes)

John Reed, a wealthy businessman, established an inter vivos trust on January 1, 1986 to provide for the financial needs of his son and wife. The written trust agreement signed by Reed provided for income to his wife, Myrna, for her life with the remainder to his son, Rodney. Reed named Mini Bank as the sole trustee and transferred stocks, bonds, and two commercial buildings to the trust. The accounting period selected for the trust was the calendar year.

During the first year of the trust’s existence, Mini made the following allocations to principal and income arising out of transactions involving the trust property:

- With regard to the sale of $25,000 of stock, $20,000 to income representing the gain on the sale of stock and $5,000 to principal representing the cost basis of the stock.
- $95,000 to income from rental receipts earned and received after the trust was created.
- $6,000 to income and $2,000 to principal as a result of a stock dividend of 400 shares of $5 par value common stock at a time when the stock was selling for $20 per share.
- $10,000 to income for bond interest received and which is payable semi-annually on April 1 and October 1.
- $35,000 to principal as a result of mortgage payments made by the trust on the commercial buildings.

The instrument creating the trust is silent as to the allocation of the trust receipts and disbursements to principal and income.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Have the requirements been met for the creation of a valid inter vivos trust?

b. Indicate the proper allocation to principal and income of the trust receipts and disbursements described above under the majority rules, ignoring the tax effect of each transaction.

M83

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 Virgili, 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.

1. What are the basic elements for the creation of a valid trust?
2. At what point in time was the trust created in this case?
3. Is the Internal Revenue Service’s denial of the shifting of the $14,000 income to the children proper?
4. Can Mr. & Mrs. Crawford, without the consent of the beneficiaries, revoke the trust, assuming the Internal Revenue Service is correct?
Selected Questions

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 obtain 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.

N83
Number 4 (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 intention 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 options.
- 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.

M84
Number 3 (Estimated time — — 15 to 20 minutes)

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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.
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.

**Business Law**

**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.

IV. Debtor-Creditor Relationships

A. Suretyship

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.

Discuss in separate paragraphs each of the above defenses asserted by Grant and indicate the amount of Grant's liability.

B. Bankruptcy

Number 5 (Estimated time — 15 to 20 minutes)

Ultra Corporation is engaged in the metal stamping business. On March 2, 1986, it filed a voluntary petition in bankruptcy seeking relief in the form of a liquidation of the business pursuant to Chapter 7 of the Bankruptcy Code. A trustee was appointed on March 10, 1986 and has commenced amassing the debtor's property. Much of Ultra's property was leased from various third parties. One of Ultra's punch presses was rented from Van Equipment Rental and Sales Corporation under a 40-month lease arrangement. The lease was heavily front loaded and provided for purchase of the punch press for $100 upon expiration of the lease. The fair market value of the punch press at expiration of the lease is estimated at $4,500. Van failed to file a financing statement or its equivalent with respect to this lease. In addition, Ultra has a 15-year lease on a warehouse which has 13 years of its term remaining. Payments on the lease are current. Dann Corp. has offered to assume all obligations under the warehouse lease and to pay Ultra $8,000 for an assignment of that lease. There is no applicable state law affecting such an assignment and the lease itself is silent in this regard. Specifically, the trustee in bankruptcy asserts that:

- The punch press lease is in essence a secured installment sales contract for which Van has an unperfected security interest and therefore the punch press should be included in the bankruptcy estate.

- As trustee she has the right to assume and assign to Dann Corp. the warehouse lease and include the $8,000 in the bankruptcy estate.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

a. Briefly discuss what property should be included in a corporate-debtor's estate in bankruptcy.

b. What rights does a trustee in bankruptcy have regarding property leased by a debtor?

c. Are the trustee's assertions concerning the punch press lease and the warehouse lease correct?
Selected Questions

M86
Number 5 (Estimated time — 15 to 20 minutes)

Ed Walsh, a sole proprietor, filed a petition in bankruptcy under the liquidation provisions of Chapter 7 of the Bankruptcy Code. Salam Corp., one of Walsh's largest creditors, wishes to prevent Walsh from receiving a discharge in bankruptcy or in the alternative to have its debt excepted from a discharge. Salam asserts to the trustee in bankruptcy that:

- Walsh neither listed nor scheduled Salam's debt at any time during the bankruptcy proceeding.
- Walsh failed to preserve his financial records which are necessary to ascertain his financial condition.
- Walsh obtained money from Salam by using false financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss the assertions of Salam, indicating the consequences if such assertions are proven correct.

b. If Walsh obtains a discharge in bankruptcy and certain creditors of Walsh wish to have the discharge revoked, discuss the various bases upon which such revocation may be granted, indicating who may request the revocation and the time within which an action requesting such revocation must be made.

M85
Number 5 (Estimated time — 15 to 20 minutes)

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?

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.
- 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.
Business Law

V. Government Regulation of Business

B. Federal Securities Acts

**M85**
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 505 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?

**M83**
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.

Will West prevail, and if so, what remedy or remedies will be available to him?
Selected Questions

VI. Uniform Commercial Code

A. Commercial Paper

M67
Number 2 (Estimated time — — 15 to 20 minutes)

Prince, Hall, & Charming, CPAs, has been retained to examine the financial statements of Hex Manufacturing Corporation. Shortly before beginning the examination for the year ended December 31, 1986, Mr. Prince received a telephone call from Hex’s president indicating that he thought some type of embezzlement was occurring because the corporation’s cash position was significantly lower than in prior years. The president then requested that Prince immediately undertake a special investigation to determine the amount of embezzlement, if any.

After a month of investigation, Prince uncovered an embezzlement scheme involving collusion between the head of payroll and the assistant treasurer. The following is a summary of Prince’s findings:

• The head of payroll supplied the assistant treasurer with punched time cards for fictitious employees. The assistant treasurer prepared invoices, receiving reports, and purchase orders for fictitious suppliers. The assistant treasurer prepared checks for the fictitious employees and suppliers which were signed by the treasurer. Then, either the assistant treasurer or the head of payroll would endorse the checks and deposit them in various banks where they maintained accounts in the names of the fictitious payees. All of the checks in question have cleared Omega Bank, the drawee.

• The embezzlement scheme had been operating for 10 months and more than $120,000 had been embezzled by the time the scheme was uncovered. The final series of defalcations included checks payable directly to the head of payroll and the assistant treasurer. These checks included skillful forgeries of the treasurer’s signature that were almost impossible to detect. This occurred while the treasurer was on vacation. These checks have also cleared Omega Bank, the drawee.

Required: Answer the following, setting forth reasons for any conclusions stated.

Will Hex or Omega bear the loss with respect to the following categories of checks:

a. those which were signed by the treasurer but payable to fictitious payees?

b. those which include the forged signature of the treasurer?

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 Charles Hardy, President
242 Oak Lane Drive
Hinsdale, Illinois 60521

Accepted by: __________________________

Hardy endorsed the instrument on the back as follows:

Pay to the order of Walter Melba
Hardy & Company
Charles Hardy, President

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?
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?

**Category Four:** The goods were shipped to the buyer and were either rightfully or wrongfully rejected.

**Category Five:** The goods were shipped to the buyer who had 30 days to return the motors if they were not suitable for use in the buyer's manufacturing operation.

**Category Six:** Identified goods are sold to a buyer and have been made available to the buyer pursuant to a written contract that is silent as to the passage of title.

**Category Seven:** The goods were shipped to a buyer who has rightfully revoked his acceptance of the goods because of a substantial manufacturing defect. The buyer is still in possession of the goods.

**Required:** Answer the following, setting forth reasons for any conclusions stated.

What role does title play under the Uniform Commercial Code? Determine whether title has passed in each of the above seven categories of transactions.

**Category One:** The goods are unfinished motors which are on the assembly line and will be completed and boxed in the future. The contracts of sale involving these unfinished motors provided that the buyers will pick them up when available at Dark's loading platform. The contracts state that the motors have been sold to the buyer and title has passed to him upon execution of the contract.

**Category Two:** The goods are shipped to buyers pursuant to contracts which provide either "F.O.B. — buyer's place of business" or "F.O.B. — Dark's loading dock." In both instances Dark retains a security interest and files a financing statement.

**Category Three:** The goods have been warehoused by Dark in a public warehouse. By the terms of these contracts, Dark is obligated to deliver a negotiable warehouse receipt in some instances and a non-negotiable warehouse receipt in others.
Selected Questions

King has adopted a calendar year for accounting purposes. Flaxx, the partner in charge of the audit, wishes to resolve the following issues pertaining to each of the transactions with Lutz:

- Who bears the risk of loss in each of the above transactions as of December 31, 1985?
- Whether title to the goods received by King as a result of the December 24 and December 30 contracts passed to King by December 31, 1985, and therefore should be included in King's ending inventory.
- Who is liable for the expenses relating to the transportation of the goods on the December 30 contracts?

The contracts between Lutz and King did not address the issues raised by Flaxx.

Required: Answer the following, setting forth reasons for any conclusions stated.

Discuss the issues raised by Flaxx.

M85

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.

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 permission 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.

a. Discuss whether the original sales contract and the subsequent change in price by Reed are enforceable under the UCC Sales Article.

b. 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?
D. Secured Transactions

**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 sales persons 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?

**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?

VII. Property

A. Real and Personal Property

**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.
Selected Questions

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?

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.

B-79
SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. The CPA and the Law

M87

Answer 3 (10 points)

a. No. Since there is no accountant-client privilege recognized at common law and there is no applicable state statute which creates an accountant-client privilege, Clark & Wall will be required to produce its workpapers. Furthermore, the right to assert the accountant-client privilege generally rests with the client and not with the accountant.

b. The elements necessary to establish a cause of action for negligence against Clark & Wall are:
   • A legal duty to protect the plaintiff (Dill) from unreasonable risk.
   • A failure by the defendant (Clark & Wall) to perform or report on an engagement with the due care or competence expected of members of its profession.
   • A causal relationship, i.e., that the failure to exercise due care resulted in the plaintiff’s loss.
   • Actual damage or loss resulting from the failure to exercise due care.

In addition to the foregoing, Dill must be able to establish that it is within a known and intended class of third party beneficiaries in order to recover damages from Clark & Wall for negligence. This is necessary because Clark & Wall has asserted that it is not in privity of contract with Dill.

c. The primary standards against which the accountant’s conduct will be tested are GAAS. Such standards are generally known as “the custom of the industry.” Failure by Clark & Wall to meet the standards of the profession will undoubtedly result in a finding of negligence. However, meeting the standard of the profession will not be conclusive evidence that Clark & Wall was not negligent, although it is of significant evidentiary value.

d. The requirements to establish actual or constructive fraud on the part of Clark & Wall are:
   1. A false representation of fact by the defendant (Clark & Wall).
   2. For actual fraud, knowledge by the defendant (Clark & Wall) that the statement is false (scienter) or that the statement is made without belief that it is truthful. Constructive fraud may be inferred from gross negligence or a reckless disregard for the truth.
   3. An intention to have the plaintiff (Dill) rely upon the false statement.
   4. “Justifiable” reliance upon the false statement.
   5. Damage resulting from said reliance.

M86

Answer 2 (10 points)

The facts reveal negligence on Field’s part in that it did not follow its own audit program nor did it make a proper investigation into the many irregularities and suspicious circumstances. Compliance with GAAP is of some evidentiary value to Field if it in fact complied with the principles set forth therein. However, the courts do not invariably accept GAAP as the conclusive test to disprove negligence. Furthermore, even if assuming GAAP were followed literally, GAAS certainly were not, under the facts stated.

Field will undoubtedly rely upon the privity defense to avoid liability to Slade, a third party to the Field-Tyler contract. However, most jurisdictions recognize the standing of a third party beneficiary to sue. Therefore, Slade would assert such status. In a majority of jurisdictions Slade would be regarded as a third party beneficiary if it is within a known and intended class of beneficiaries. Other jurisdictions have gone even further in recognizing a duty is owed to those whom the CPA should reasonably foresee as recipients of the financial statements for authorized business purposes. There are insufficient facts to determine whether Field knew that Tyler intended to use the audited financial statements to secure credit from Slade. Therefore, it is
not possible to determine whether the privity defense will bar recovery.

Fraud does not require that the party suing be in privity of contract with the defendant. However, the most significant problem in pleading based upon fraud is that fraud requires a knowledge of falsity (scienter) or a recognized substitute therefor. Based upon the facts, Field did not actually know of management’s fraud. However, it may be guilty of conduct which may be deemed to be a reckless disregard for the truth. The courts also resort to the constructive fraud theory where the facts are compelling, i.e., a shutting of one’s eyes to the obvious. Sometimes, the conduct is labeled gross negligence, and an inference of fraud may be drawn from this by the trier of fact.

Business Law

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.

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 them-

M85

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 “unhappy 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.
selves 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 foreseen 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 (Ultra­mares), 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.

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 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.

II. Business Organizations

B. Partnerships and Joint Ventures

N86 Answer 2 (10 points)

Typically, a general partnership is formed by an agreement between or among two or more persons, whether the agreement is written, oral, or implied. No filing of a partnership agreement is necessary in order to legally create the general partnership. In contrast, a limited partnership can only be formed where a state statute permits such formation. In addition, a duly signed certificate of limited partnership must be completed and filed with the appropriate state or local agency. A limited partnership, like a general partnership, is formed by two or more persons. However, unlike a general partnership, the limited partnership must have as members one or more general partners and one or more limited partners.

As a limited partner Slavin would not be able to participate in the daily management of the partnership’s business if she wishes to limit her liability to her investment in the partnership. Thus, if Slavin intends to be involved in the daily operations of the partnership and to participate in the control of the partnership, she should consider becoming a general partner since general partners have rights in the management and conduct of the partnership’s business.

In her capacity as a limited partner, Slavin’s liability would be limited to her investment in the partnership for partnership debts if her interest is fully paid and nonassessable. However, if Slavin were to become a general partner, she would have unlimited liability which would allow partnership creditors to satisfy the debts of the partnership out of Slavin’s personal assets. Unless otherwise provided in the partnership agreement, Slavin has the right to assign her limited partnership interest and may also substitute the third party as a limited partner if all the members (except the assignor) consent thereto. Similarly, as a general partner, Slavin may assign her interest in the partnership and the third party may become a general partner if all of the partners consent.

A clause providing for the partnership to continue after the death of a general partner is valid and the partnership will continue. The clause has relatively little if any effect where a limited partner dies since the limited partnership continues upon the death of one of the limited partners, whether or not the clause is contained in the certificate.

N85 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
mure 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 correct. 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.

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 membership, i.e., his apparent authority in the partnership after his 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.

C. Corporations

M86
Answer 4 (10 points)

a. Generally, any person who is a holder of record of shares at least six months immediately preceding her demand or is the holder of record of at least 5% of all the outstanding shares of the corporation may, upon written demand, have the right to examine at any reasonable time for any proper purpose, the relevant books, records, and shareholder list of the corporation. In addition, any court of competent jurisdiction may upon proof by a shareholder of a proper purpose, irrespective of the period of time such shareholder has been a shareholder of record and irrespective of the number of shares held by her, compel the production for examination by the shareholder of such books, records, and shareholder list that is deemed relevant.

However, Rice may properly refuse to allow Mead to examine Sky’s books, records, and shareholder list where the shareholder (Mead) has within two years sold or offered for sale any list of shareholders or has otherwise improperly used any information secured through any prior examination. Thus, it would appear that despite the fact that Mead has met the six-month holding requirement and holds in excess of 5% of the stock, Rice’s refusal to permit Mead access to Sky’s books, records, and shareholder list was proper since Mead had attempted to sell the shareholder list 13 months ago.

b. Mead personally does not have the right to remove Rice as president of Sky. However, Rice may be removed as the president of Sky by the board of directors whenever, in its judgment, the best interests of the corporation will be served. However, such removal is without prejudice to the contract rights of the person so removed. Thus, Rice may be removed with or without cause and the vote of the shareholders at its annual meeting is not required for such removal. However, if Rice is removed without cause Sky may be liable to Rice for breach of contract.

c. Mead is entitled to payment for her shares. A shareholder has the right to dissent from a merger and to obtain payment for her shares in the event that the corporation in which she is a shareholder is a party to a proposed plan of merger. If Mead strictly complies with the statutory requirements as a dissenter, she will be entitled to receive the fair value of her shares (an appraisal remedy). The fact that such a remedy is not provided for in the Articles of Incorporation is irrelevant where a state statute provides a dissenting shareholder with such a remedy.

M88
Answer 4 (10 points)

a. Although officers are generally insulated from personal liability for the negligence of the corporation or its employees, they are subject to personal liability in
tort for their own negligent conduct or participation, even while engaged in corporate business activities. Shareholders generally will not be held liable for the negligence of the corporation unless they have in some way participated in the negligent act. Based on the facts presented, Major is personally liable to Fox for his own negligence even though the negligent acts were committed while engaged in corporate business activities. Major may also be liable because of his status as a shareholder if the corporate veil is pierced.

A corporation is liable under the doctrine of respondent superior for the torts committed by its agents and employees (officers) in the course of their employment. Thus, Dix will also be liable to Fox for the negligence of Major.

The liability insurance carried by Dix will provide coverage for Dix and Major up to $500,000 of liability to Fox. If Fox were to obtain a judgment in excess of $500,000, Major and Dix would be liable for the uninsured balance.

b. Pine's assertion that Major is personally liable to the extent of $6,000 for the common shares issued to Major is incorrect as to the dollar amount of his potential liability. Where a corporation issues par value stock in return for property or services rendered having a fair market value less than the par value, the shareholder purchasing the stock at the discounted price will remain potentially liable to the creditors of the corporation. The potential liability is the difference between the fair market value of the consideration given and the total par value of the stock. Stock issued at such a discounted price is commonly referred to as "watered stock." In this case Major's part payment by a promissory note and future services is insufficient consideration. Therefore, Major is potentially liable to Pine and the other corporate creditors for $9,500—calculated as follows:

First Acquisition

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total par value (1,000 shares × $10 par value)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Less: Consideration given (fair market value of property)</td>
<td>[3,500]</td>
</tr>
<tr>
<td>Potential liability on first acquisition</td>
<td>$  6,500</td>
</tr>
</tbody>
</table>

Second Acquisition

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total par value (1,000 shares × $10 par value)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Less: Consideration given (services rendered)</td>
<td>[7,000]</td>
</tr>
<tr>
<td>Potential liability on second acquisition</td>
<td>3,000</td>
</tr>
<tr>
<td>Total Potential Liability</td>
<td>$  9,500</td>
</tr>
</tbody>
</table>

Pine's assertion that Major may be personally liable as a result of his directing customers to make checks payable to him in his individual capacity and depositing the checks in his individual account without recording the checks on the corporation's books is correct. Although a corporation may be established to limit the liability of the shareholders, the courts will pierce the corporate veil (disregard the corporate entity) and hold the shareholders personally liable when the corporation is used to perpetuate a fraud or in a closely-held corporation when the shareholders fail to treat the corporation as a separate business entity. The commingling of the corporation's funds with Major's own funds amounts to a disregard of the corporate entity and will likely subject Major to personal liability for the debts of Dix.

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.

M83

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 must have 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 irreparable 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.

D. Estates and Trusts

M87

Answer 5 (10 points)

a. Yes. The elements necessary to set up a valid inter vivos trust have been met. John Reed as the creator (grantor or settlor) transferred stocks, bonds, and buildings which constituted the trust res (corpus or principal) to the trust with a present intent to create a trust. The trust instrument which designated Mini as trustee was set up for a lawful purpose and named Myrna as the income beneficiary and Rodney as the remainder.

b. Where the trust instrument is silent as to the allocation of the trust receipts and disbursements to principal and income, the following rules apply:

With respect to the $25,000 proceeds on the sale of the stock, most states require that the entire $25,000 be allocated to principal. Therefore, the allocation of $20,000 to income and $5,000 to principal is incorrect. The allocation of $95,000 in rental receipts to income is correct since the entire amount was earned and received after the creation of the trust.

The allocation of the stock dividend to principal and income is incorrect in the vast majority of states. Even under the minority rule, an allocation of a stock dividend to principal based on the par value of the shares distributed is incorrect, i.e., 400 shares × $5 par value = $2,000. Under the majority rule, the entire stock dividend is allocated to principal.

The allocation of the full $10,000 bond interest to income is incorrect since one-half ($2,500) of the semiannual payment received on April 1, 1986, had already accrued when the trust was created on January 1, 1986. Therefore, the proper allocation should be $2,500 to principal and $7,500 to income.

The $35,000 of mortgage payments allocated to principal is correct to the extent such payments represent a repayment of the mortgage debt. Any portion of such payments which are deemed to be interest on the mortgage should be allocated to income.
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 transeree 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

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 opening 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 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.

Abel’s assertion that his liability to Reid will be discharged because of Reid’s failure to comply with the express contractual promise not to compete with Beach is correct. Unlike the defense of the principal debtor’s minority, a material breach of the underlying contract between the principal debtor and creditor may be properly asserted by the surety. The creditor’s failure to perform in accordance with the material terms of the underlying contract without justification will discharge the principal debtor’s obligation to perform, thereby increasing the risk of the principal debtor’s non-performance. Thus, the surety will also be discharged from liability due to his own increased risk of loss on the surety contract. It seems clear that Reid’s opening of a travel agency across the street from Beach’s business after only 19 months constituted a material breach of the sale contract. Therefore, Abel will be discharged from his surety obligation.

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 dis-
close 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.

N83
Answer 4 (10 points)

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.

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

M86

Answer 5 (10 points)

a. In general, property of the estate in bankruptcy is comprised of all legal and equitable interests of the debtor in property as of the commencement of the case, i.e., the filing of the bankruptcy petition. Property of the estate also includes post-petition income or proceeds from the property of the estate after the commencement of the case. In addition, certain property acquired by the debtor or which the debtor becomes entitled to acquire within 180 days after the filing of the bankruptcy petition will be included in the estate. Also the estate may include certain property interests that can be recovered by the trustee from third parties.

b. The legal effect of the filing of a bankruptcy petition on a debtor's leases permits a bankruptcy trustee to:

1. Assume and retain the debtor's leases, or
2. Assume and assign such leases, or
3. Reject the debtor's leases.

A trustee's assumption or rejection of a lease is subject to court approval. In a Chapter 7 case, a lease is deemed rejected by operation of law unless it is assumed by the trustee within 60 days after the order for relief.

c. The trustee's first assertion with regard to the punch press lease is correct. Where the agreement entered into between the parties is a true lease and not a disguised secured installment sales contract, the subject matter of the lease will not be included in the bankruptcy estate.

Whether a lease is intended as security and thereby treated as a secured installment sales contract is determined by the facts of each case. The inclusion of an option to purchase does not of itself make the lease one intended as security. However, where by the terms of the lease the lessee will become or has the option to become the owner of the property for no additional consideration or for a nominal consideration, the lease is likely one intended for security.

Under the facts of our case, the option to purchase the punch press for $100 at the expiration of the lease would be deemed nominal consideration since the fair market value of the punch press at that time is estimated at $4,500. Thus, the lease is one intended as security and a security interest arises. In order for Van to perfect its security interest it must file a financing statement. In this case, Van did not file a financing statement or its equivalent and thus Van has an unperfected security interest in the punch press.

The UCC Article on Secured Transactions states that an unperfected security interest is subordinate to a person who becomes a lien creditor before the security interest is perfected. It defines, in part, a lien creditor as a trustee in bankruptcy from the date of the filing of the bankruptcy petition. In addition, the Bankruptcy Code gives the trustee in bankruptcy the power to avoid any transfer of property of the debtor that under non-bankruptcy law is voidable as to a creditor who extended credit and obtained a judicial lien on the date of the filing of the bankruptcy petition. Even though the UCC uses the term subordinate instead of voidable, a security interest that would be subordinate to a creditor that obtained a judicial lien on the date of the filing of the bankruptcy petition is voidable by the trustee. Thus, Van's unperfected security interest may be avoided by the trustee in bankruptcy and the punch press should be included in the debtor's estate in bankruptcy.

The trustee's second assertion is correct. Since there is no applicable state law affecting such an assignment and the lease itself is silent in this regard, the trustee may assume and assign the lease. In this case, the warehouse lease has a substantial value to other potential lessees and therefore due to the favorable circumstances indicated commands a substantial premium of $8,000. The debtor's estate in bankruptcy will receive this upon assignment (sale) of the lease to Dann.

M86

Answer 5 (10 points)

a. The failure by Walsh to list or schedule a debt at anytime during the bankruptcy proceeding, if proven, would result in that debt being excepted from a discharge in bankruptcy. Such is the rule where the creditor is unable to file a proof of claim in time and lacks notice or actual knowledge of the case.

Proof of Walsh's failure to preserve financial records necessary to ascertain his financial condition, if unjustified, would result in Walsh being denied a discharge in bankruptcy. The purpose of this rule is to deny the debtor a discharge for his wrongdoing in connection with the bankruptcy proceeding.

The effect of Walsh obtaining money by use of false financial statements, if proven, would result in Salam's debt being excepted from a discharge in bankruptcy. In order to obtain such an exception from discharge Salam must establish that the money was obtained by the use of a statement in writing in respect to Walsh's financial condition that is materially false, on which Salam reasonably relied, and which Walsh made or published with intent to deceive.

b. On request of the trustee in bankruptcy or a creditor, and after notice and a hearing, the court will revoke a previously granted discharge in bankruptcy if:

- Such discharge was obtained through the fraud of the debtor and the party requesting that the discharge be revoked did not know of such fraud until after the discharge was granted; or
- The debtor acquired property that is property of the estate, or became entitled to acquire property that
would be property of the estate, and knowingly and
fraudulently failed to report the acquisition of, or
entitlement to, such property, or to deliver or sur-
render such property to the trustee; or

- The debtor has refused (1) to obey any lawful order
of the court, (2) has refused to testify on the ground
of privilege against self-incrimination despite being
granted immunity, or (3) has refused to testify after
improperly invoking the constitutional privilege
against self-incrimination.

The trustee in bankruptcy or a creditor may request a
revocation of a discharge in bankruptcy under the first
ground set forth above if such action is commenced
within one year after the discharge was granted. If the
requested revocation is based on the second or third
grounds set forth above, then revocation must be sought
within one year after the granting of such discharge or
the date the case was closed, whichever is later.

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 es-

tablish 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 cred-
tor 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 con-
temporaneous exchange for new value given to Baker
and was in fact a substantially contemporaneous ex-
change, 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 di-

orce 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 individ-
ually. 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.

N83
Answer 3

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 re-
solved as follows:

- The claim for an exemption allowance for the cot-
tage will be disallowed. The Bankruptcy Code pro-
vides for one exemption for one’s principal
residence, not to exceed $7,500. The home will qual-
ify 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 con-
duct 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 col-
lateral or its monetary equivalent. If this is insuffi-
cient 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.
Business Law

V. Government Regulation of Business

B. Federal Securities Acts

M85
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-reported 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.

M83
Answer 3

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.

VI. Uniform Commercial Code

A. Commercial Paper

M87
Answer 2 (10 points)

a. Checks paid to fictitious payees. Hex will bear the ultimate loss on these items (the fictitious or non-existent "employees" and the fictitious suppliers). As a general rule, forged signatures of drawers and forged endorsements are real defenses which are valid even against a holder in due course. However, when some of these activities are engaged in by the employees of an employer-drawer of the checks, a different rule is applied. Essentially, this rule negates these real defenses in certain cases thereby shifting the loss to the employer-drawer. The key rule is contained in the Uniform Commercial Code's Article on Commercial Paper which deals with "Imposters; Signature of Payee." In essence, this rule makes the endorsement or signature of the agent or employee of the drawer (Hex) "effective" where the agent has supplied the drawer the name of the payee intending the latter to have no such interest.
Insofar as Omega is concerned, it will be treated as if it had honored valid orders to pay and need not refund to Hex the amounts it paid. The orders are valid since the forged endorsements are not treated as unauthorized.

b. Checks which contain the forged signature of the treasurer. From the facts it is apparent that the treasurer had the authority to sign checks and not the assistant treasurer or head of payroll. Thus, the forger of the treasurer’s signature was an “unauthorized signature” under the UCC.

As to these checks, the UCC provides that such signatures are wholly inoperative since the guilty parties had no authority to sign the treasurer’s or any other authorized party’s name as the drawer on behalf of Hex.

As between Hex and Omega, there is an obligation on the part of the bank to know the signatures of its drawer-depositors. Since Omega has paid the items it cannot recoup the loss from Hex. However, the bank has two possible ways to escape liability to Hex. First, it can resort to the UCC section which imposes upon a customer to whom items (checks) are returned, a duty to exercise reasonable care and promptness in discovering and reporting unauthorized signatures. Another possibility is to establish negligence on the part of Hex which substantially contributed to the forgeries. Unless the bank can demonstrate that one of these exceptions applies, it will bear the loss.

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.

C. Sales

N86 Answer 3 (10 points)

The draftsmen of the Uniform Commercial Code assigned a relatively minor role to title. The status of title is irrelevant in allocating risk of loss, determining remedies, and making other determinations under the UCC. Each of these issues is dealt with independent of title. However, the passage of title for a price is the basic definition of a sale which is the focus of Article 2 of the UCC.

Category One: Title has not passed upon execution of the contract by the parties. Although the UCC favors the contractual allocation of title by the parties, it does not permit a sale to take place until the goods are in existence and have been identified to the contract.

Category Two: In the absence of an explicit agreement, the term “F.O.B.—buyer’s place of business” is a destination point contract, and title passes on tender at the destination. On the other hand, the term “F.O.B.—Dark’s loading dock” is a shipping point contract, and title passes to the buyer at the time and place of shipment. Taking a security interest and filing a financing statement is irrelevant for purposes of determining whether title has passed.

Category Three: Title will pass upon delivery of the negotiable warehouse receipt to the buyer in this type of transaction. Likewise, title will pass upon delivery of the warehouse receipt if it is nonnegotiable.
Category Four: A rejection or other refusal by the buyer, whether or not justified, revests title in the seller.

Category Five: This is a sale on approval transaction and therefore title passes to the buyer when the goods are accepted.

Category Six: Title passed at the time the contract was made because the goods were identified and available at that time.

Category Seven: Since the revocation of acceptance of the goods is rightful, title revests in the seller upon revocation of the acceptance.

M86
Answer 3 (10 points)

In the absence of an agreement to the contrary, King bears the risk of loss for the goods received on December 28, 1985 since the risk of loss on a sale or return contract passes to the buyer in accordance with the shipping terms of the contract. The fact that King received the goods on December 28, 1985, clearly indicates that the risk of loss passed to King prior to December 31, 1985. With respect to the destruction of the fur coats, the risk of loss on December 31, 1985, was on Lutz since King never received the coats. Where the seller is a merchant, as is the case here, the risk of loss passes to the buyer upon the buyer’s receipt of the goods. The December 30 contract containing the delivery term “F.O.B. purchaser’s business” is a destination contract and the risk of loss in such a contract passes to the buyer when the goods are so tendered at the point of destination as to enable the buyer to take delivery. Thus, the risk of loss on December 31 remained with Lutz since the merchandise did not arrive at King’s business until January 2, 1986. The second contract entered into on December 30 containing the delivery term “C.I.F.” is a shipping point contract whereby the risk of loss passes to the buyer when the goods are duly delivered to the carrier. Of course in either of the December 30 contracts, the party bearing the risk of loss may be entitled to recover damages from the carrier or if insurance is provided for, as in the “C.I.F.” contract, from the insurance company.

Unless otherwise agreed, title in a sale or return contract passes to the buyer at the time and place the seller completes his performance with reference to the physical delivery of the goods. Title remains with the buyer until the buyer returns the goods to the seller. Therefore, King should include the goods on sale or return in its ending inventory since title had passed, at the latest, when the goods were received on December 28 and the goods had not been returned by December 31. Title to the merchandise on the December 30 contract containing the delivery term “F.O.B. purchaser’s business” remained with the seller until the goods were tendered at the point of destination, i.e., the purchaser’s business. Thus, the goods should not be included in King’s ending inventory since the goods were not delivered to King’s business until January 2, 1986. Conversely, the December 30 contract containing the delivery term “C.I.F.” resulted in title being transferred to King on December 31, 1985, the day the carrier received the goods. Such is the rule since the “C.I.F.” term is a shipping point contract whereby title passes to the buyer at the time and place of shipment. Therefore, the goods should be included in King’s ending inventory despite King’s lack of physical possession.

Since the December 30 agreements between King and Lutz did not stipulate who would pay the expenses relating to the transportation of the goods, Lutz is obligated to pay for transporting the goods to King’s place of business pursuant to the “F.O.B. purchaser’s business” term. Under the “C.I.F.” contract King is obligated to pay Lutz a sum covering the cost of the goods, insurance, and freight to the destination.

N85
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.
Unofficial Answers

- 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.

M85
Answer 2 (10 points)

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.

M83
Answer 5

Part b.

- 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.

B-95
D. Secured Transactions

N84 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 acquiring 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.

N83 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.

VII. Property

A. Real and Personal Property

N84 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 co-tenants. 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 co-trustee.

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.

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.
## NOVEMBER 1987

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(Commercial Law)

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EXAMINATION IN ACCOUNTING PRACTICE — PART I

November 4, 1987; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

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<th>Estimated Minutes</th>
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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. 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 may 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.
Examination Questions — November 1987

Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple choice items. Select the best answer for each of the items. Use a 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 for each question.

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

Number 1 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to a variety of financial accounting problems.

Items to be Answered

1. Apex Corporation’s checkbook balance on December 31, 1986, was $160,000. The same date Apex held the following items in its safe:
   • A $5,000 check payable to Apex, dated January 2, 1987, that was not included in the December 31 checkbook balance.
   • A $3,500 check payable to Apex, deposited December 22 and included in the December 31 checkbook balance, that was returned by the bank on December 30 marked NSF. The check was redeposited January 2, 1987, and cleared January 7.
   • A $25,000 check, payable to a supplier and drawn on Apex’s account, that was dated and recorded December 31, but was not mailed until January 15, 1987.

   In its December 31, 1986 balance sheet, Apex should report cash at
   a. $156,500
   b. $161,500
   c. $181,500
   d. $185,000

2. During 1985 Garr Company purchased marketable equity securities as a short-term investment. At December 31, 1985, the balance in the allowance to reduce marketable equity securities to market was $23,000. There were no security transactions during 1986. Pertinent information at December 31, 1986, is as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$245,000</td>
<td>$230,000</td>
</tr>
<tr>
<td>B</td>
<td>180,000</td>
<td>182,000</td>
</tr>
<tr>
<td></td>
<td>$425,000</td>
<td>$412,000</td>
</tr>
</tbody>
</table>

   In its 1986 income statement, Garr should report a (an)
   a. Recovery of unrealized loss of $8,000.
   b. Recovery of unrealized loss of $10,000.
   c. Unrealized loss of $13,000.
   d. Unrealized loss of $15,000.

3. On July 1, 1986, Fox Company purchased 400 of the $1,000 face amount, 8% bonds of DeY Company for $369,200 to yield 10% per annum. The bonds, which mature on July 1, 1991, pay interest semiannually on January 1 and July 1. Fox uses the interest method of amortization and the bonds are appropriately recorded as a long-term investment. The bonds should be reported on Fox’s December 31, 1986 balance sheet at
   a. $397,540
   b. $374,120
   c. $371,660
   d. $366,740

4. On January 1, 1986, Mann Company’s allowance for doubtful accounts had a credit balance of $30,000. During 1986 Mann charged $64,000 to doubtful accounts expense, wrote off $46,000 of uncollectible accounts receivable, and unexpectedly recovered $12,000 of bad debts written off in the prior year. The allowance for doubtful accounts balance at December 31, 1986, would be
   a. $48,000
   b. $60,000
   c. $64,000
   d. $94,000

5. Kemp Company had the following consignment transactions during December 1986:

   Inventory shipped on consignment to
   Ashe Company $9,000
   Freight paid by Kemp 450
   Inventory received on consignment from
   Fenn Company 6,000
   Freight paid by Fenn 250

   No sales of consigned goods were made through December 31, 1986. Kemp’s December 31, 1986 balance sheet should include consigned inventory at
   a. $9,450
   b. $9,000
   c. $6,250
   d. $6,000
6. On January 1, 1987, Beal Corporation adopted a plan to accumulate funds for a new plant building to be erected beginning July 1, 1992, at an estimated cost of $1,200,000. Beal intends to make five equal annual deposits in a fund that will earn interest at 8% compounded annually. The first deposit is made on July 1, 1987. Present value and future amount factors are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Factor</th>
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<tbody>
<tr>
<td>Present value of 1 at 8% for 5 periods</td>
<td>0.68</td>
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<tr>
<td>Present value of 1 at 8% for 6 periods</td>
<td>0.63</td>
</tr>
<tr>
<td>Future amount of ordinary annuity of 1 at 8% for 5 periods</td>
<td>5.87</td>
</tr>
<tr>
<td>Future amount of annuity in advance of 1 at 8% for 5 periods</td>
<td>6.34</td>
</tr>
</tbody>
</table>

Beal should make five annual deposits (rounded) of
a. $151,200
b. $163,200
c. $189,300
d. $204,400

7. On December 31, 1986, Park Company sold used equipment to Ott Corp. and received a noninterest bearing note requiring payment of $5,000 annually for ten years. The first payment is due December 31, 1987, and the prevailing rate of interest for this type of note at date of issuance is 12%. Present value factors are as follows:

<table>
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<tr>
<td>Present value of 1 at 12% for 10 periods</td>
<td>0.322</td>
</tr>
<tr>
<td>Present value of ordinary annuity of 1 at 12% for 10 periods</td>
<td>5.650</td>
</tr>
</tbody>
</table>

In its December 31, 1986 balance sheet, Park should report the carrying amount of the note at
a. $16,100
b. $21,750
c. $28,250
d. $50,600

8. Bloy Company pays all salaried employees on a biweekly basis. Overtime pay, however, is paid in the next biweekly period. Bloy accrues salaries expense only at its December 31 year end. Data relating to salaries earned in December 1986 are as follows:

- Last payroll was paid on 12/26/86, for the 2-week period ended 12/26/86.
- Overtime pay earned in the 2-week period ended 12/26/86 was $4,200.
- Remaining work days in 1986 were December 29, 30, and 31, on which days there was no overtime.
- The recurring biweekly salaries total $75,000.

Assuming a five-day work week, Bloy should record a liability at December 31, 1986, for accrued salaries of
a. $22,500
b. $26,700
c. $45,000
d. $49,200

9. Dart Company's accounting records indicated the following information:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Inventory, 1/1/86</td>
<td>$500,000</td>
</tr>
<tr>
<td>Purchases during 1986</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Sales during 1986</td>
<td>3,200,000</td>
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</table>

A physical inventory taken on December 31, 1986, resulted in an ending inventory of $575,000. Dart's gross profit on sales has remained constant at 25% in recent years. Dart suspects some inventory may have been taken by a new employee. At December 31, 1986, what is the estimated cost of missing inventory?

a. $25,000
b. $100,000
c. $175,000
d. $225,000

10. Wall Company bought a trademark from Black Corporation on January 1, 1986, for $112,000. An independent consultant retained by Wall estimated that the remaining useful life is 30 years. Its unamortized cost on Black's accounting records was $56,000. Wall decided to write off the trademark over the maximum period allowed. How much should be amortized for the year ended December 31, 1986?

a. $1,120
b. $1,400
c. $2,240
d. $2,800

11. West Company adopted a defined benefit pension plan on January 1, 1986. West amortizes the prior service cost over 16 years and funds prior service cost by making equal payments to the fund trustee at the end of each of the first ten years. The service (normal) cost is fully funded at the end of each year. The following data are available for 1986:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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<tr>
<td>Service (normal) cost for 1986</td>
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<tr>
<td>Prior service cost:</td>
<td></td>
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<tr>
<td>Amortized</td>
<td>41,700</td>
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<tr>
<td>Funded</td>
<td>57,200</td>
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West's prepaid pension cost at December 31, 1986, is
a. $0
b. $15,500
c. $41,700
d. $57,200

12. On September 1, 1985, Pine Company issued a note payable to National Bank in the amount of $1,800,000, bearing interest at 12%, and payable in three equal annual principal payments of $600,000. On this date the bank's prime rate was 11%. The first interest and principal payment was made on September 1, 1986. At December 31, 1986, Pine should record accrued interest payable of

a. $44,000
b. $48,000
c. $66,000
d. $72,000
13. Lee Company's current liabilities at December 31, 1986, totaled $1,500,000 before any necessary year-end adjustment relating to the following:

- On December 23, 1986, a vendor authorized Lee to return, for full credit, goods shipped and billed at $45,000 on December 10, 1986. The returned goods were shipped by Lee on December 29, 1986. A $45,000 credit memo was received and recorded by Lee on January 7, 1987.
- During December 1986, Lee received $75,000 from Marr, a customer, as an advance payment for a bottling machine which Lee will construct to Marr's specifications. From this transaction Lee has a $75,000 credit balance in its account receivable from Marr at December 31, 1986.

At December 31, 1986, what amount should Lee report as total current liabilities?

a. $1,455,000  
b. $1,470,000  
c. $1,530,000  
d. $1,575,000

14. Glen Apparel Shop, Inc. sells gift certificates redeemable only when merchandise is purchased. The certificates have an expiration date two years after issuance date. Upon redemption or expiration, Glen recognizes the unearned revenue as realized. Data for 1986 are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unearned revenue, 1/1/86</td>
<td>$75,000</td>
</tr>
<tr>
<td>Gift certificates sold</td>
<td>250,000</td>
</tr>
<tr>
<td>Gift certificates redeemed</td>
<td>205,000</td>
</tr>
<tr>
<td>Expired gift certificates</td>
<td>15,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>60%</td>
</tr>
</tbody>
</table>

At December 31, 1986, Glen should report unearned revenue of

a. $42,000  
b. $100,000  
c. $105,000  
d. $120,000

15. Ryan, Inc. began operations on January 1, 1986, and appropriately uses the installment method of accounting. The following data are available for 1986:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Installment accounts receivable</td>
<td>$600,000</td>
</tr>
<tr>
<td>Installment sales for 1986</td>
<td>1,050,000</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>40%</td>
</tr>
</tbody>
</table>

Under the installment method, Ryan’s deferred gross profit at December 31, 1986, would be

a. $360,000  
b. $270,000  
c. $240,000  
d. $180,000

16. Included in Kerr Corporation’s liability account balances at December 31, 1986, were the following:

- 14% note payable issued October 1, 1986, maturing September 30, 1987: $250,000
- 16% note payable issued April 1, 1984, payable in six equal annual installments of $100,000 beginning April 1, 1985: $400,000

Kerr's December 31, 1986, financial statements were issued on March 31, 1987. On January 15, 1987, the entire $400,000 balance of the 16% note was refinanced by issuance of a long-term obligation payable in a lump-sum. In addition, on March 10, 1987, Kerr consummated a noncancelable agreement with the lender to refinance the 14%, $250,000 note on a long-term basis, on readily determinable terms that have not yet been implemented. Both parties are financially capable of honoring the agreement, and there have been no violations of the agreement's provisions. On the December 31, 1986 balance sheet, the amount of the notes payable that Kerr should classify as short-term obligations is

a. $0  
b. $100,000  
c. $250,000  
d. $350,000

17. Dix, Inc., a calendar-year corporation, reported the following operating income (loss) before income tax for its first three years of operations:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>$100,000</td>
</tr>
<tr>
<td>1985</td>
<td>$(200,000)</td>
</tr>
<tr>
<td>1986</td>
<td>400,000</td>
</tr>
</tbody>
</table>

There are no permanent or timing differences between operating income (loss) for financial and income tax reporting purposes. When filing its 1985 tax return, Dix did not elect to forgo the carryback of its loss for 1985. Assume a 40% tax rate for all years. What amount should Dix report as its income tax liability at December 31, 1986?

a. $160,000  
b. $120,000  
c. $80,000  
d. $60,000

18. On December 31, 1986, Lane, Inc. sold equipment to Noll, and simultaneously leased it back for 12 years. Pertinent information at this date is as follows:

<table>
<thead>
<tr>
<th>Statement</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales price</td>
<td>$480,000</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>360,000</td>
</tr>
<tr>
<td>Estimated remaining economic life</td>
<td>15 years</td>
</tr>
</tbody>
</table>

At December 31, 1986, how much should Lane report as deferred revenue from the sale of the equipment?

a. $0  
b. $110,000  
c. $112,000  
d. $120,000
19. Cobb Company sells appliance service contracts agreeing to repair appliances for a two-year period. Cobb's past experience is that, of the total dollars spent for repairs on service contracts, 40% is incurred evenly during the first contract year and 60% evenly during the second contract year. Receipts from service contract sales for the two years ended December 31, 1986, are as follows:

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receipts from contracts</td>
<td>$500,000</td>
<td>600,000</td>
</tr>
</tbody>
</table>

Receipts from contracts are credited to unearned service contract revenue. Assume that all contract sales are made evenly during the year. What amount should Cobb report as unearned service contract revenue at December 31, 1986?

- $360,000
- $470,000
- $480,000
- $630,000

20. On January 1, 1983, Cory, Inc. purchased a building for $1,800,000. For 1986 the building was depreciated $60,000 for financial statement reporting. For income tax reporting, Cory uses the ACRS and is allowed a cost recovery deduction of $145,000 for 1986. Assume an income tax rate of 40%. At December 31, 1986, what amount should Cory add to its deferred income tax liability?

- $34,000
- $36,000
- $51,000
- $58,000

Number 2 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to a variety of financial accounting problems.

**Items to be Answered**

21. Lake Construction Company has consistently used the percentage-of-completion method of recognizing income. During 1985 Lake entered into a fixed-price contract to construct an office building for $10,000,000. Information relating to the contract is as follows:

<table>
<thead>
<tr>
<th>At December 31,</th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of completion</td>
<td>20%</td>
<td>60%</td>
</tr>
<tr>
<td>Estimated total cost at completion</td>
<td>$7,500,000</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>Income recognized (cumulative)</td>
<td>500,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Contract costs incurred during 1986</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. $3,200,000</td>
<td>b. $3,300,000</td>
<td>c. $3,500,000</td>
</tr>
</tbody>
</table>

22. Among the items reported on Neal Corporation's income statement for the year ended December 31, 1986, are the following:

- Interest received on municipal bonds $10,000
- Amortization of goodwill $18,000

Timing differences for interperiod tax allocation amount to

- a. $28,000
- b. $18,000
- c. $10,000
- d. $0

23. On December 30, 1986, Frey Company leased equipment from Hull. Pertinent lease transaction data are as follows:

- The estimated seven-year useful equipment life coincides with the lease term.
- The first of the seven equal annual $200,000 lease payments was paid on December 31, 1986.
- Hull’s implicit interest rate of 12% is known to Frey.
- Frey’s incremental borrowing rate is 14%.
- Present values of an annuity of 1 in advance for seven periods are 5.11 at 12%, and 4.89 at 14%, respectively.

At inception of the lease, Frey should record a capitalized lease liability of

- a. $1,400,000
- b. $1,022,000
- c. $978,000
- d. $0

24. On December 31, 1985, Roe Company leased a machine under a capital lease for a period of ten years, contracting to pay $100,000 on signing the lease and $100,000 annually on December 31 of the next nine years. The present value at December 31, 1985, of the ten lease payments over the lease term discounted at 10% was $676,000. At December 31, 1986, Roe’s total capital lease liability is

- a. $486,000
- b. $518,400
- c. $533,600
- d. $607,960

25. On June 30, 1987, Town, Inc. had outstanding 10%, $1,000,000 face amount, 15-year bonds maturing on June 30, 1995. Interest is paid on June 30 and December 31, and bond discount and bond issue costs are amortized on these dates. The unamortized balances on June 30, 1987, of bond discount and bond issue costs were $55,000 and $20,000, respectively. Town reacquired all of these bonds at 96 on June 30, 1987, and retired them. Ignoring income taxes, how much gain or loss should Town record on the bond retirement?

- a. Loss of $15,000.
- b. Loss of $35,000.
- c. Gain of $5,000.
- d. Gain of $40,000.
26. On January 1, 1987, Colt Company issued ten-year bonds with a face amount of $1,000,000 and a stated interest rate of 8% payable annually on January 1. The bonds were priced to yield 10%. Present value factors are as follows:

<table>
<thead>
<tr>
<th></th>
<th>At 8%</th>
<th>At 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of 1 for 10 periods</td>
<td>0.463</td>
<td>0.386</td>
</tr>
<tr>
<td>Present value of an ordinary annuity of 1 for 10 periods</td>
<td>6.710</td>
<td>6.145</td>
</tr>
</tbody>
</table>

The total issue price (rounded) of the bonds was:
- a. $1,000,000
- b. $980,000
- c. $920,000
- d. $880,000

27. During 1986 Cain Corporation incurred the following costs in connection with the issuance of bonds:

- Printing and engraving: $15,000
- Legal fees: 80,000
- Fees paid to independent accountants for registration information: 10,000
- Commissions paid to underwriter: 150,000

What amount should be recorded as a deferred charge to be amortized over the term of the bonds?
- a. $15,000
- b. $150,000
- c. $245,000
- d. $255,000

28. On January 1, 1987, Wolf, Inc. issued its 10% bonds in the face amount of $500,000, that mature on January 1, 1997. The bonds were issued for $443,000 to yield 12%, resulting in bond discount of $57,000. Wolf uses the interest method of amortizing bond discount. Interest is payable July 1 and January 1. For the six months ended June 30, 1987, Wolf should report bond interest expense at
- a. $25,000
- b. $26,580
- c. $27,850
- d. $28,420

29. Ward, Inc. had outstanding 10%, $1,000,000 face amount convertible bonds maturing on December 31, 1991, on which interest is paid December 31 and June 30. After amortization through June 30, 1987, the unamortized balance in the bond premium account was $30,000. On that date, bonds with a face amount of $500,000 were converted into 20,000 shares of $20 par common stock. Ward incurred expenses of $10,000 in connection with the conversion. Recording the conversion by the book value (carrying amount) method, Ward should credit additional paid-in capital for
- a. $120,000
- b. $115,000
- c. $105,000
- d. $100,000

30. Ball Corporation had the following infrequent gains during 1986:
- A $240,000 gain on sale of a plant facility; Ball continues similar operations at another location.
- A $90,000 gain on repayment of a long-term note denominated in a foreign currency.
- A $190,000 gain on reacquisition and retirement of bonds.

In its 1986 income statement, how much should Ball report as total infrequent gains which are not considered extraordinary?
- a. $520,000
- b. $430,000
- c. $330,000
- d. $280,000

31. Kent Corp. carries $10,000,000 comprehensive public liability insurance with a $200,000 deductible clause. A suit for personal injury damages was brought against Kent in 1986. Kent's counsel believes it probable that the insurance company will settle out of court for an estimated amount of $350,000. At December 31, 1986, Kent should report an accrued liability of
- a. $350,000
- b. $200,000
- c. $150,000
- d. $0

32. On July 1, 1986, Day Company purchased Parr Corp. ten-year, 8% bonds with a face amount of $400,000 for $358,000, which included $8,000 of accrued interest. The bonds, which mature on April 1, 1994, pay interest semiannually on April 1 and October 1. Using the interest method, Day recorded bond discount amortization of $1,500 for the six months ended December 31, 1986. From this long-term investment, Day should report 1986 revenue of
- a. $14,000
- b. $14,500
- c. $16,000
- d. $17,500

33. Adam Company received dividends from its common stock investments during the year ended December 31, 1986, as follows:
- A stock dividend of 200 shares from Brock Corp. was received on July 25, 1986, on which date the market price of Brock's shares was $20 per share. Adam owns less than 1% of Brock's common stock.
- A cash dividend of $60,000 from Celt Corp., in which Adam owns a 25% interest. A majority of Celt's directors are also directors of Adam.

What amount of dividend revenue should Adam report in its 1986 income statement?
- a. $0
- b. $4,000
- c. $60,000
- d. $64,000
Accounting Practice — Part I

34. On June 30, 1987, Dorr, Inc. declared and issued a 10% common stock dividend. Prior to the dividend, Dorr had 30,000 shares of $10 par common stock issued and outstanding. The market price of Dorr’s common stock on June 30, 1987, was $27 per share. As a result of this stock dividend, by what amount should Dorr’s total stockholders’ equity increase or (decrease)?
   a. ($81,000)
   b. $51,000
   c. $30,000
   d. $0

35. On November 5, 1986, a Dunn Corp. truck was in an accident with an auto driven by Bell. Dunn received notice on January 12, 1987, of a lawsuit for $700,000 damages for personal injuries suffered by Bell. Dunn Corp.’s counsel believes it is probable that Bell will be awarded an estimated amount in the range between $200,000 and $450,000, and that $300,000 is a better estimate of potential liability than any other amount. Dunn’s accounting year ends on December 31, and the 1986 financial statements were issued on March 2, 1987. What amount of loss should Dunn accrue at December 31, 1986?
   a. $0
   b. $200,000
   c. $300,000
   d. $450,000

36. Clay Company assigns patent rights, for which advance royalties are received in some cases and, in others, royalties are remitted within 60 days after each license year end. The following data are available from Clay’s accounting records:

<table>
<thead>
<tr>
<th>Royalties receivable</th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unearned royalties</td>
<td>45,000</td>
<td>65,000</td>
</tr>
</tbody>
</table>

During 1986 Clay received royalty remittances of $250,000. In its 1986 income statement, Clay should report royalty revenue of
   a. $225,000
   b. $230,000
   c. $235,000
   d. $255,000

37. Conn Company purchased a new machine for $480,000 on January 1, 1986, and leased it to East the same day. The machine has an estimated 12-year life, and will be depreciated $40,000 per year. The lease is for a three-year period expiring January 1, 1989, at an annual rental of $85,000. Additionally, East paid $30,000 to Conn as a lease bonus to obtain the three-year lease. For 1986 Conn incurred insurance expense of $8,000 for the leased machine. What is Conn’s 1986 operating profit on this leased asset?
   a. $67,000
   b. $55,000
   c. $47,000
   d. $37,000

38. Mill Company began operations on January 1, 1985, and appropriately uses the installment method of accounting. The following data are available for 1985 and 1986:

<table>
<thead>
<tr>
<th>Installment sales</th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash collections</td>
<td>400,000</td>
<td>500,000</td>
</tr>
<tr>
<td>1985 sales</td>
<td>400,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>30%</td>
<td>40%</td>
</tr>
</tbody>
</table>

   The realized gross profit for 1986 is
   a. $240,000
   b. $390,000
   c. $440,000
   d. $600,000

39. Rex Company accepted a $10,000, 2% interest bearing note from Brooks Company on December 31, 1986, in exchange for a machine with a list price of $8,000 and a cash price of $7,500. The note is payable on December 31, 1988. In its 1986 income statement, Rex should report the sale at
   a. $7,500
   b. $8,000
   c. $10,000
   d. $10,400

40. On February 24, 1986, Bart Company purchased 2,000 shares of Winn Corp.’s newly issued 6% cumulative $75 par preferred stock for $152,000. Each share carried one detachable stock warrant entitling the holder to acquire at $10 one share of Winn no-par common stock. On February 25, 1986, the market price of the preferred stock ex-warrants was $72 a share and the market price of the stock warrants was $8 a warrant. On December 29, 1986, Bart sold all the stock warrants for $20,500. The gain on the sale of the stock warrants was
   a. $0
   b. $500
   c. $4,500
   d. $5,300

Number 3 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to a variety of financial accounting problems.

Items to be Answered

41. On October 1, 1986, Poe Corporation’s operating plant, located in Kansas, was destroyed by an earthquake. The portion of the resultant loss not covered by insurance was $1,400,000. Poe’s income tax rate for 1986 is 40%. In Poe’s income statement for the year ended December 31, 1986, this event should be reported as an extraordinary loss of
   a. $0
   b. $560,000
   c. $840,000
   d. $1,400,000
42. The following information was taken from Kay Company's accounting records for the year ended December 31, 1986:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in raw materials inventory</td>
<td>$15,000</td>
</tr>
<tr>
<td>Decrease in finished goods inventory</td>
<td>$35,000</td>
</tr>
<tr>
<td>Raw materials purchased</td>
<td>$430,000</td>
</tr>
<tr>
<td>Direct-labor payroll</td>
<td>$200,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>$300,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

There was no work-in-process inventory at the beginning or end of the year. Kay's 1986 cost of goods sold is

- a. $950,000
- b. $965,000
- c. $975,000
- d. $995,000

43. Korn Company incurred the following costs during 1986:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modification of a chemical product</td>
<td>$135,000</td>
</tr>
<tr>
<td>Trouble-shooting in connection with breakdowns during commercial production</td>
<td>$150,000</td>
</tr>
<tr>
<td>Design of tools, jigs, molds and dies involving new technology</td>
<td>$170,000</td>
</tr>
<tr>
<td>Seasonal or other periodic design changes to existing products</td>
<td>$185,000</td>
</tr>
<tr>
<td>Laboratory research aimed at discovery of new technology</td>
<td>$215,000</td>
</tr>
</tbody>
</table>

In its income statement for the year ended December 31, 1986, Korn should report research and development expense of

- a. $520,000
- b. $470,000
- c. $385,000
- d. $335,000

44. Orr Corporation had a realized foreign exchange loss of $13,000 for the year ended December 31, 1986, and must determine whether the following items will require year-end adjustment:

- Orr had a $7,000 gain resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1986.
- Orr had an account payable to an unrelated foreign supplier payable in the supplier's local currency. The U.S. dollar equivalent of the payable was $60,000 on the October 31, 1986 invoice date, and it was $64,000 on December 31, 1986. The invoice is payable on January 30, 1987.

In Orr's 1986 consolidated income statement, what amount should be included as foreign exchange loss?

- a. $6,000
- b. $10,000
- c. $13,000
- d. $17,000

45. Strand, Inc. provides an incentive compensation plan under which its president receives a bonus equal to 10% of the corporation's income in excess of $200,000 before income tax but after deduction of the bonus. If income before income tax and bonus is $640,000 and the tax rate is 40%, the amount of the bonus would be

- a. $40,000
- b. $44,000
- c. $58,180
- d. $64,000

46. Clark Company's allowance for doubtful accounts had a credit balance of $12,000 at December 31, 1985. Clark accrues doubtful accounts expense at 4% of credit sales. During 1986 Clark's credit sales amounted to $1,500,000, and uncollectible accounts totaling $48,000 were written off. The aging of accounts receivable indicated that a $50,000 allowance for doubtful accounts was required at December 31, 1986. Clark's doubtful accounts expense for 1986 would be

- a. $48,000
- b. $50,000
- c. $60,000
- d. $86,000

47. On May 15, 1986, Hart, Inc. approved a plan to dispose of a segment of its business. It is expected that the sale will occur on February 1, 1987, at a selling price of $1,000,000. Disposal costs incurred by Hart totaled $150,000, all of which were paid during 1986. The segment had actual or estimated operating losses as follows:

<table>
<thead>
<tr>
<th>Date Range</th>
<th>Loss Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/86 to 5/14/86</td>
<td>$130,000</td>
</tr>
<tr>
<td>5/15/86 to 12/31/86</td>
<td>$50,000</td>
</tr>
<tr>
<td>1/1/87 to 1/31/87</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

The carrying amount of the segment at the date of sale was expected to be $1,750,000. Ignore the income tax effects. What amount should Hart report as a loss on disposal of the segment in its 1986 income statement?

- a. $0
- b. $900,000
- c. $915,000
- d. $965,000

48. At December 31, 1985, Lex, Inc. had 600,000 shares of common stock outstanding. On April 1, 1986, an additional 180,000 shares of common stock were issued for cash. Lex also had $5,000,000 of 8% convertible bonds outstanding at December 31, 1986, which are convertible into 150,000 shares of common stock. The bonds were considered common stock equivalents at the time of issuance and are dilutive in the 1986 earnings per share computation. No bonds were issued or converted into common stock during 1986. What is the number of shares that should be used in computing primary earnings per share for 1986?

- a. 735,000
- b. 780,000
- c. 885,000
- d. 930,000
Items 49 and 50 are based on the following data:

Munn Corporation's income statement for the year ended December 31, 1986, shows pretax income of $300,000. The following items are treated differently on the tax return and in the accounting records:

<table>
<thead>
<tr>
<th>Item</th>
<th>Tax return</th>
<th>Accounting records</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty expense</td>
<td>$170,000</td>
<td>$195,000</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>150,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Premiums on officers' life insurance</td>
<td>None</td>
<td>60,000</td>
</tr>
</tbody>
</table>

Assume that Munn's tax rate for 1986 is 40%.

49. What is the current portion of Munn's total income tax expense for 1986?
   a. $166,000
   b. $120,000
   c. $130,000
   d. $144,000

50. What is the deferred portion of Munn's total income tax expense for 1986?
   a. $6,000
   b. $14,000
   c. $20,000
   d. $24,000

51. On January 1, 1986, Farr, Inc. changed to the straight-line method of depreciation from an accelerated method of depreciation for its machinery and equipment. The accumulated depreciation through December 31, 1985, was $600,000 higher than if the straight-line method had been used. The change was made for financial statement reporting but not for income tax reporting. Farr's income tax rate is 40% for 1985 and 1986. In Farr's 1986 income statement, the cumulative effect of this change in accounting principle should be reported at
   a. $600,000
   b. $360,000
   c. $240,000
   d. $0

52. Rand, Inc. had 20,000 shares of common stock outstanding at January 1, 1986. On May 1, 1986, it issued 10,500 shares of common stock. Outstanding all year were 10,000 shares of nonconvertible preferred stock on which a dividend of $4 per share was paid in December 1986. Net income for 1986 was $96,700. Rand's earnings per share for 1986 are
   a. $1.86
   b. $2.10
   c. $2.84
   d. $3.58

53. Dean 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, 1987, are as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 2/1/87</td>
<td>$180,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>1,020,000</td>
<td>1,575,000</td>
</tr>
<tr>
<td>Markups, net</td>
<td></td>
<td>175,000</td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>1,705,000</td>
</tr>
<tr>
<td>Estimated normal shoplifting losses</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Markdowns, net</td>
<td></td>
<td>125,000</td>
</tr>
</tbody>
</table>

Under the approximate lower of average cost or market retail method, Dean's estimated inventory at July 31, 1987 is
   a. $90,000
   b. $96,000
   c. $102,000
   d. $150,000

Items 54 and 55 are based on the following data:

Rice Wholesaling Corp. accounts for inventory on a FIFO basis. There were 8,000 units in inventory on January 1, 1986. Costs were incurred and goods purchased as follows during 1986:

<table>
<thead>
<tr>
<th>Year</th>
<th>Historical costs</th>
<th>Units purchased</th>
<th>Units sold</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st quarter</td>
<td>$410,000</td>
<td>7,000</td>
<td>7,500</td>
</tr>
<tr>
<td>2nd quarter</td>
<td>550,000</td>
<td>8,500</td>
<td>7,300</td>
</tr>
<tr>
<td>3rd quarter</td>
<td>425,000</td>
<td>6,500</td>
<td>8,200</td>
</tr>
<tr>
<td>4th quarter</td>
<td>630,000</td>
<td>9,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Total</td>
<td>$2,015,000</td>
<td>31,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Rice estimates that the current cost per unit of inventory was $57 at January 1, 1986, and $71 at December 31, 1986.

54. In Rice's voluntary supplementary information restated into current cost, the December 31, 1986 inventory should be reported at
   a. $576,000
   b. $585,000
   c. $630,000
   d. $639,000

55. In Rice's voluntary supplementary information restated into current cost, the cost of goods sold for 1986 would be
   a. $1,920,000
   b. $1,944,000
   c. $2,100,000
   d. $2,130,000
Items 56 and 57 are based on the following data:

On January 1, 1986, Fay Corporation established an employee stock ownership plan (ESOP). Selected transactions relating to the ESOP during 1986 were as follows:

- On April 1, 1986, Fay contributed $30,000 cash and 3,000 shares of its $10 par common stock to the ESOP. On this date the market price of the stock was $18 a share.

- On October 1, 1986, the ESOP borrowed $100,000 from Union National Bank and acquired 5,000 shares of Fay's common stock in the open market at $17 a share. The note is for one year, bears interest at 10%, and is guaranteed by Fay.

- On December 15, 1986, the ESOP distributed 6,000 shares of Fay common stock to employees of Fay in accordance with the plan formula.

56. In its 1986 income statement, how much should Fay report as compensation expense relating to the ESOP?
   a. $184,000
   b. $120,000
   c. $ 84,000
   d. $ 60,000

57. In Fay's December 31, 1986 balance sheet, how much should be reported as a reduction of shareholders' equity and as an endorsed note payable in respect of the ESOP?

<table>
<thead>
<tr>
<th>Reduction of shareholders' equity</th>
<th>Endorsed note payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $0</td>
<td>$100,000</td>
</tr>
<tr>
<td>c. $100,000</td>
<td>$0</td>
</tr>
<tr>
<td>d. $100,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

58. Flax Company's accounting records disclosed the following information as of and for the year ended December 31, 1986:

Net credit sales $3,150,000
Net cash sales 630,000
Accounts receivable at beginning 500,000
Accounts receivable at end 900,000

Flax's accounts receivable turnover is
a. 5.4 times.
b. 4.5 times.
c. 4.2 times.
d. 3.5 times.

59. Cord Corporation discloses supplementary industry segment information for its two reportable segments. Data for 1986 are available as follows:

<table>
<thead>
<tr>
<th></th>
<th>Segment E</th>
<th>Segment W</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$750,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Traceable operating expenses</td>
<td>325,000</td>
<td>130,000</td>
</tr>
</tbody>
</table>

Additional 1986 expenses are as follows:

- Indirect operating expenses $120,000
- General corporate expenses 100,000

Appropriately selected common expenses are allocated to segments based on the ratio of each segment's sales to total sales. The 1986 operating profit for segment E was
a. $260,000
b. $335,000
c. $395,000
d. $425,000

60. On December 31, 1985 and 1986, Taft Corporation had 100,000 shares of common stock and 50,000 shares of noncumulative and nonconvertible preferred stock issued and outstanding. Additional information is as follows:

<table>
<thead>
<tr>
<th>Stockholders' equity at 12/31/86</th>
<th>$4,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income year ended 12/31/86</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Dividends on preferred stock year ended 12/31/86</td>
<td>300,000</td>
</tr>
<tr>
<td>Market price per share of common stock at 12/31/86</td>
<td>72</td>
</tr>
</tbody>
</table>

The price-earnings ratio on common stock at December 31, 1986 was
a. 5 to 1.
b. 6 to 1.
c. 8 to 1.
d. 9 to 1.
The plant asset and accumulated depreciation accounts of Pell Corporation had the following balances at December 31, 1985:

<table>
<thead>
<tr>
<th>Plant asset</th>
<th>Accumulated depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$350,000</td>
</tr>
<tr>
<td>Land improvements</td>
<td>$45,000</td>
</tr>
<tr>
<td>Building</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>$405,000</td>
</tr>
<tr>
<td>Automobiles</td>
<td>$112,000</td>
</tr>
</tbody>
</table>

Depreciation methods and useful lives

Land improvements — Straight-line; 15 years.

Building — 150% declining balance; 20 years.

Machinery and equipment — Straight-line; ten years.

Automobiles — 150% declining balance; three years.

Depreciation is computed to the nearest month. No salvage values are recognized.

Transactions during 1986

- On January 2, 1986, machinery and equipment were purchased at a total invoice cost of $260,000, which included a $5,500 charge for freight. Installation costs of $27,000 were incurred.

- On March 31, 1986, a machine purchased for $58,000 on January 2, 1982, was sold for $36,500.

- On May 1, 1986, expenditures of $50,000 were made to repave parking lots at Pell's plant location. The work was necessitated by damage caused by severe winter weather.

- On November 1, 1986, Pell acquired a tract of land with an existing building in exchange for 10,000 shares of Pell's $20 par common stock, that had a market price of $38 a share on this date. Pell paid legal fees and title insurance totaling $23,000. The last property tax bill indicated assessed values of $240,000 for land and $60,000 for building. Shortly after acquisition, the building was razed at a cost of $35,000 in anticipation of new building construction in 1987.


Required:

a. Prepare a schedule analyzing the changes in each of the plant assets during 1986, with detailed supporting computations. Disregard the related accumulated depreciation accounts.

b. For each asset classification, prepare a schedule showing depreciation expense for the year ended December 31, 1986.

c. Prepare a schedule showing the gain or loss from each asset disposal that would be recognized in Pell's income statement for the year ended December 31, 1986.
Presented below are the condensed statements of financial position of Public Relations Associates as of December 31, 1986 and 1985, and the condensed statement of income for the year ended December 31, 1986.

**Public Relations Associates**

**CONDENSED STATEMENTS OF FINANCIAL POSITION**  
December 31, 1986 and 1985

<table>
<thead>
<tr>
<th>Assets</th>
<th>1986</th>
<th>1985</th>
<th>Net change increase (decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$326,000</td>
<td>$140,000</td>
<td>$186,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>223,000</td>
<td>184,000</td>
<td>39,000</td>
</tr>
<tr>
<td>Investment in King, Inc., at equity</td>
<td>275,000</td>
<td>233,000</td>
<td>42,000</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>635,000</td>
<td>550,000</td>
<td>85,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(95,000)</td>
<td>(65,000)</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Excess cost over book value of investment in King (net)</td>
<td>76,000</td>
<td>78,000</td>
<td>(2,000)</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$1,440,000</td>
<td>$1,120,000</td>
<td>$320,000</td>
</tr>
</tbody>
</table>

| Liabilities and Partners' Equity |  |
| Accounts payable and accrued expenses | $160,000 | $135,000 | $25,000 |
| Mortgage payable | 125,000 | 135,000 | (10,000) |
| Partners' equity | 1,155,000 | 850,000 | 305,000 |
| **Total liabilities and partners' equity** | $1,440,000 | $1,120,000 | $320,000 |

**Public Relations Associates**

**CONDENSED STATEMENT OF INCOME**  
For the Year Ended December 31, 1986

| |  |
| Fee revenue | $1,332,000 |
| Operating expenses | 970,000 |
| Operating income | 362,000 |
| Equity in earnings of King, Inc. (net of $2,000 amortization of excess cost over book value) | 88,000 |
| **Net income** | $450,000 |
Number 5 (continued)

Additional information:

- On December 31, 1985, partners' capital and profit sharing percentages were as follows:

<table>
<thead>
<tr>
<th>Capital</th>
<th>Profit sharing %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burr</td>
<td>$540,000</td>
</tr>
<tr>
<td>Cox</td>
<td>340,000</td>
</tr>
<tr>
<td></td>
<td>60%</td>
</tr>
<tr>
<td></td>
<td>40%</td>
</tr>
<tr>
<td></td>
<td>$850,000</td>
</tr>
</tbody>
</table>

- On January 1, 1986, the partners admitted Davis to the partnership for a cash payment of $170,000 to Public Relations Associates. In addition, Davis paid a $100,000 cash bonus directly to Burr and Cox. This amount was divided $60,000 to Burr and $40,000 to Cox. The new profit sharing arrangement is as follows:

  Burr      50%
  Cox       30%
  Davis     20%

- On July 1, 1986, Public Relations Associates purchased an office computer for $85,000 which included $10,000 for sales tax, delivery, and installation. There were no dispositions of property and equipment during 1986.
- Throughout 1986, Public Relations Associates owned 25% of the common stock of King, Inc. During 1986, King paid cash dividends totaling $192,000 and reported net income of $360,000. Public's 1986 amortization of excess cost over book value in King was $2,000.
- Partners' drawings for 1986 were as follows:

  Burr $140,000
  Cox 100,000
  Davis 75,000

  $315,000

Required:
  b. Prepare an analysis of changes in partners' capital accounts for the year ended December 31, 1986.
NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>All questions are required:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 1</td>
<td>10</td>
<td>45</td>
</tr>
<tr>
<td>No. 2</td>
<td>10</td>
<td>45</td>
</tr>
<tr>
<td>No. 3</td>
<td>10</td>
<td>45</td>
</tr>
<tr>
<td>No. 4</td>
<td>10</td>
<td>45</td>
</tr>
<tr>
<td>No. 5</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>50</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 may 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._

N-14
Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple choice items. Select the best answer for each of the items. Use a 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 for each question.

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

Number 1 (Estimated time —- 45 to 55 minutes)

Select the best answer for each of the following items relating to the federal taxation of individuals, estates, and trusts. The answers should be based on the Internal Revenue Code and Tax Regulations in effect for the tax period specified in the item. If no tax period is specified, use the current Internal Revenue Code and Tax Regulations. If 1987 is indicated as the tax year, assume that the year has ended.

Items to be Answered

1. John Budd files a joint return with his wife. Budd’s employer pays 100% of the cost of all employees’ group-term life insurance under a qualified plan. Under this plan, the maximum amount of tax-free coverage that may be provided for Budd by his employer is
   a. $100,000
   b. $50,000
   c. $10,000
   d. $5,000

2. In 1987, Al Oran bought a paved vacant lot adjacent to his retail store for use as a customers’ parking lot at a cost of $15,000. In addition, Oran bought new store fixtures costing $8,000. What portion of these assets constitutes capital assets?
   a. $0
   b. $8,000
   c. $15,000
   d. $23,000

3. Emil Gow owns a two-family house which has two identical apartments. Gow lives in one apartment and rents out the other. In 1987, the rental apartment was fully occupied and Gow received $7,200 in rent. During the year ended December 31, 1987, Gow paid the following:
   Real estate taxes $6,400
   Painting of rental apartment 800
   Annual fire insurance premium 600

   In 1987, depreciation for the entire house was determined to be $5,000. What amount should Gow include in his adjusted gross income for 1987?
   a. $2,900
   b. $800
   c. $400
   d. $100

4. With regard to tax recognition of alimony in connection with a 1987 divorce, which one of the following statements is correct?
   a. The divorced couple may be members of the same household at the time payments are made.
   b. Payments may be made either in cash or in property.
   c. If the payor spouse pays premiums for insurance on his life as a requirement under the divorce agreement, the premiums are alimony if the payor spouse owns the policy.
   d. Payments must terminate at the death of the payee spouse.

5. For the year ended December 31, 1986, Don Raff earned $1,000 interest at Ridge Savings Bank on a certificate of deposit scheduled to mature in 1988. In January 1987, before filing his 1986 income tax return, Raff incurred a forfeiture penalty of $500 for premature withdrawal of the funds. Raff should treat this $500 forfeiture penalty as a
   a. Reduction of interest earned in 1986, so that only $500 of such interest is taxable on Raff’s 1986 return.
   b. Deduction from 1987 adjusted gross income, deductible only if Raff itemizes his deductions for 1987.
   c. Penalty not deductible for tax purposes.
   d. Deduction from gross income in arriving at 1987 adjusted gross income.

6. Under the cash method of reporting, an individual should report gross income
   a. Only for the year in which income is actually received in cash.
   b. Only for the year in which income is actually received either in cash or in property.
   c. For the year in which income is either actually or constructively received in cash only.
   d. For the year in which income is either actually or constructively received either in cash or in property.
Examination Questions — November 1987

7. The following information pertains to installment sales of personal use property made by Fred Dale in his retail furniture store:

<table>
<thead>
<tr>
<th>Year of sale</th>
<th>Installment sales</th>
<th>Gross profit</th>
<th>Collections in 1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$ 50,000</td>
<td>$15,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>1986</td>
<td>100,000</td>
<td>40,000</td>
<td>30,000</td>
</tr>
<tr>
<td>1987</td>
<td>150,000</td>
<td>75,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

These sales were not under a revolving credit plan. Under the installment method, Dale should report gross profit for 1987 of
a. $ 35,000
b. $ 75,000
c. $ 80,000
d. $130,000

8. Under a $150,000 insurance policy on her deceased father's life, Mary Green is to receive $12,000 per year for 15 years. Of the $12,000 received in 1987, the amount subject to income tax is
a. $0
b. $ 1,000
c. $ 2,000
d. $12,000

9. In 1987, Gail Judd received the following dividends from

Benefit Life Insurance Co., on Gail's life insurance policy (Total dividends received have not yet exceeded accumulated premiums paid) $100
Safe National Bank, on bank's common stock 300
Roe Mfg. Corp., a Delaware corporation, on preferred stock 500

What amount of dividend income should Gail report in her 1987 income tax return?
 a. $900
 b. $800
 c. $500
 d. $300

10. Paul Crane, age 25, and single with no dependents, had an adjusted gross income of $30,000 in 1987, exclusive of $2,000 in unemployment compensation benefits received in 1987. The amount of Crane's unemployment compensation benefits taxable for 1987 is
 a. $2,000
 b. $1,000
 c. $500
 d. $0

11. Disregarding extensions of time for filing, within how many months after the date of Alan's death is the federal estate tax return due?
 a. 2½
 b. 3½
 c. 9
 d. 12

12. In computing the taxable estate, the executor of Alan's estate should claim a marital deduction of
 a. $ 250,000
 b. $ 375,000
 c. $ 700,000
 d. $1,025,000

13. If the executor of Alan's estate elects the alternate valuation method, all remaining undistributed property included in the gross estate must be valued as of how many months after Alan's death?
 a. 12
 b. 9
 c. 6
 d. 3

14. Smith and Jones, both U.S. citizens, died in 1987. Neither made any lifetime gifts. At the dates of death, Smith's gross estate was $510,000, and Jones' gross estate was $610,000. A federal estate tax return must be filed for

<table>
<thead>
<tr>
<th>Smith</th>
<th>Jones</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</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. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

15. If a taxpayer omits from his or her income tax return an amount that exceeds 25% of the gross income reported on the return, the Internal Revenue Service can issue a notice of deficiency within a maximum period of
 a. 3 years from the date the return was filed, if filed before the due date.
 b. 3 years from the date the return was due, if filed before the due date.
 c. 6 years from the date the return was due, if filed before the due date.
 d. 6 years from the date the return was due, if filed by the due date.
16. Ben Carr, a calendar-year taxpayer, was 65 years old on December 30, 1986. Ben filed his 1986 individual income tax return on April 1, 1987, and attached a check for the balance of tax due as shown on the return. On August 15, 1987, Ben realized that he had inadvertently failed to claim the additional exemption to which he was entitled by virtue of having attained age 65 in 1986. In order for Ben to recover the tax that he would have saved by claiming the extra exemption, he must file a refund claim no later than
   b. April 1, 1990.
   c. April 15, 1990.

17. In 1987, Sam Dunn provided more than half the support for his wife, his father’s brother, and his cousin. Sam’s wife was the only relative who was a member of Sam’s household. None of the relatives had any income, nor did any of them file an individual or a joint return. All of these relatives are U.S. citizens. Which of these relatives should be claimed as a dependent or dependents on Sam’s 1987 return?
   a. Only his wife.
   b. Only his father’s brother.
   c. Only his cousin.
   d. His wife, his father’s brother, and his cousin.

---

**Number 2 (Estimated time — 45 to 55 minutes)**

Select the best answer for each of the following items relating to the federal taxation of corporations, partnerships, and exempt organizations. 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. If 1987 is indicated as the tax year, assume that the year has ended.

**Items to be Answered**

---

**Items 21 through 26** are based on the following data:

Eric Bay was the sole stockholder of Lee Corp., an accrual basis taxpayer engaged principally in retailing operations. Lee’s retained earnings at December 31, 1986, amounted to $2,000,000. For the year ended December 31, 1987, Lee’s book income, before income taxes, was $600,000. Included in the computation of this $600,000 were the following:

- Gain on sale of land used in business: $20,000
- Loss on sale of long-term investments in marketable securities: $30,000
- Dividend income from unaffiliated taxable domestic corporations: $4,000
- Keyman insurance premiums paid on Bay’s life (Lee is beneficiary): $1,000
- Group term life insurance premiums paid on $25,000 life insurance policies for employees (employees’ dependents are beneficiaries): $15,000
- Contribution to State University (authorized by Board of Directors in December 1987; to be paid March 3, 1988): $100,000
- Amortization of organization costs (total organization costs of $6,000 were incurred in January 1984, and are being amortized over a 10-year period for financial statement purposes): $600

In 1980, Lee had reacquired 1,000 shares of its own $10 par common stock at a cost of $25,000. This stock was held as treasury stock until May 1987, when it was reissued to James Smith at its fair market value of $33,000.

21. In computing taxable income for 1987, Lee should deduct a net capital loss of
   a. $15,000
   b. $10,000
   c. $5,000
   d. $0
22. The dividend income Lee should include in its 1987 taxable income is
   a. $4,000
   b. $3,200
   c. $800
   d. $0

23. In computing taxable income for 1987, what amount should Lee deduct for keyman and group life insurance premiums?
   a. $8,000
   b. $15,000
   c. $15,500
   d. $16,000

24. With regard to Lee's contribution to State University, Lee can
   a. Not deduct any portion of the $100,000 in 1987, because the contribution was not paid until 1988.
   b. Deduct the entire $100,000 in its 1987 return.
   c. Elect to carry back to 1986 a portion of the $100,000 that does not exceed the deduction ceiling for 1986 and 1987.
   d. Elect to deduct in its 1987 return any portion of the $100,000 that does not exceed the deduction ceiling for 1987.

25. In computing taxable income for 1987, what is the maximum deduction that Lee can claim for organization costs, assuming that the appropriate election was made on a timely basis?
   a. $1,200
   b. $600
   c. $300
   d. $0

26. How much should Lee report in its 1987 return as long-term capital gain on the issuance of its treasury stock to Smith?
   a. $0
   b. $8,000
   c. $23,000
   d. $33,000

27. Tau Corp., which has been operating since 1980, has an October 31 year end, which coincides with its natural business year. On May 15, 1987, Tau filed the required form to elect S corporation status. All of Tau's stockholders consented to the election, and all other requirements were met. The earliest date that Tau can be recognized as an S corporation is

28. For the year ended December 31, 1987, Bard Corp.'s income per accounting records, before federal income taxes, was $450,000 and included the following:

   - State corporate income tax refunds $4,000
   - Life insurance proceeds on officer’s death 15,000
   - Net loss on sale of securities bought for investment in 1976 20,000

   Bard's 1987 taxable income was
   a. $435,000
   b. $451,000
   c. $455,000
   d. $470,000

29. In the filing of a consolidated income tax return for a corporation and its wholly-owned subsidiaries, intercompany dividends between the parent and subsidiary corporations are
   a. Fully taxable.
   b. Included in taxable income to the extent of 80%.
   c. Included in taxable income to the extent of 20%.
   d. Not taxable.

30. If a corporation's tentative minimum tax exceeds the regular tax, the excess amount is
   a. Carried back to the preceding taxable year.
   b. Carried back to the third preceding taxable year.
   c. Payable in addition to the regular tax.
   d. Subtracted from the regular tax.

31. If an exempt organization is a charitable trust, then unrelated business income is
   a. Not subject to tax.
   b. Taxed at rates applicable to corporations.
   c. Subject to tax even if such income is less than $1,000.
   d. Subject to tax only for the amount of such income in excess of $1,000.

32. Which one of the following statements is correct with regard to exempt organizations?
   a. An organization is automatically exempt from tax merely by meeting the statutory requirements for exemption.
   b. Exempt organizations that are required to file annual information returns must disclose the identity of all substantial contributors, in addition to the amount of contributions received.
   c. An organization will automatically forfeit its exempt status if any executive or other employee of the organization is paid compensation in excess of $150,000 per year, even if such compensation is reasonable.
   d. Exempt status of an organization may not be retroactively revoked.
33. To qualify as an exempt organization, the applicant
   a. Must fall into one of the specific classes upon
      which exemption is conferred by the Internal
      Revenue Code.
   b. Cannot, under any circumstances, be a foreign
      corporation.
   c. Cannot, under any circumstances, engage in
      lobbying activities.
   d. Cannot be exclusively a social club.

34. The personal holding company tax may be imposed
   a. As an alternative tax in place of the corporation’s
      regularly computed tax.
   b. If more than 50% of the corporation’s stock is
      owned, directly or indirectly, by more than ten
      stockholders.
   c. If at least 60% of the corporation’s adjusted
      ordinary gross income for the taxable year is
      personal holding company income, and the
      stock ownership test is satisfied.
   d. In conjunction with the accumulated earnings
      tax.

35. The accumulated earnings tax
   a. Should be self-assessed by filing a separate
      schedule along with the regular tax return.
   b. Applies only to closely held corporations.
   c. Can be imposed on S corporations that do not
      regularly distribute their earnings.
   d. Cannot be imposed on a corporation that has
      undistributed earnings and profits of less than
      $150,000.

36. Pursuant to a plan of corporate reorganization
    adopted in June 1987, Lois Pell exchanged 100 shares
    of Ral Corp. common stock that she had purchased in March
    1987 at a cost of $10,000 for 150 shares of Lars Corp.
    common stock having a fair market value of $12,000. Pell’s
    recognized gain on this exchange was
    a. $0.
    b. $2,000 ordinary income.
    c. $2,000 short-term capital gain.
    d. $2,000 long-term capital gain.

37. Dave Cole’s adjusted basis for his interest in Marb
    Associates, a partnership, was $50,000. This amount
    included $20,000 of partnership liabilities for which Cole
    was personally liable. Marb had no unrealized receivables
    or substantially appreciated inventory. After having been
    paid his share of partnership income for the tax year, Cole
    sold his entire interest in Marb for $40,000 cash and a
    release from all partnership liabilities. Cole’s recognized
    gain or loss on the sale of his interest in Marb was
    a. $0.
    b. $10,000 ordinary income.
    c. $10,000 capital gain.
    d. $10,000 capital loss.

Items 38 and 39 are based on the following data:

Mike Reed, a partner in Post Co., received the
following distribution from Post:

<table>
<thead>
<tr>
<th>Post’s basis</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$11,000</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Before this distribution, Reed’s basis in Post was
$25,000.

38. If this distribution were nonliquidating, Reed’s
    recognized gain or loss on the distribution would be
    a. $11,000 gain.
    b. $9,000 loss.
    c. $1,500 loss.
    d. $0.

39. If this distribution were in complete liquidation of
    Reed’s interest in Post, Reed’s basis for the land would be
    a. $14,000
    b. $12,500
    c. $5,000
    d. $1,500

40. Sara Loy is a member of a four-person equal part-
    nership. In 1987, Sara sold 100 shares of a listed stock
    to the partnership for the stock’s fair market value of
    $20,000. Sara’s basis for this stock, that was purchased
    in 1980, was $14,000. Sara’s recognized gain on the sale
    of this stock was
    a. $0
    b. $1,500
    c. $4,500
    d. $6,000

Number 3 (Estimated time —— 45 to 55 minutes)

Select the best answer for each of the following items
relating to a variety of not-for-profit and governmental
accounting problems.

Items to be Answered

41. Cura Hospital’s property, plant, and equipment, net
    of depreciation, amounted to $10,000,000, with related
    mortgage liabilities of $1,000,000. What amount should
    be included in the restricted fund grouping?
    a. $0
    b. $1,000,000
    c. $9,000,000
    d. $10,000,000
42. For the summer session of 1987, Ariba University assessed its students $1,700,000 (net of refunds), covering tuition and fees for educational and general purposes. However, only $1,500,000 was expected to be realized because scholarships totaling $150,000 were granted to students, and tuition remissions of $50,000 were allowed to faculty members’ children attending Ariba. What amount should Ariba include in the unrestricted current funds as revenues from student tuition and fees?
   a. $1,500,000
   b. $1,550,000
   c. $1,650,000
   d. $1,700,000

43. Park College is sponsored by a religious group. Volunteers from this religious group regularly contribute their services to Park, and are paid nominal amounts to cover their commuting costs. During 1986, the total amount paid to these volunteers aggregated $12,000. The gross value of services performed by them, determined by reference to lay-equivalent salaries, amounted to $300,000. What amount should Park record as expenditures in 1986 for these volunteers’ services?
   a. $312,000
   b. $300,000
   c. $12,000
   d. $0

44. Abbey University’s unrestricted current funds comprised the following:

| Assets | $5,000,000 |
| Liabilities (including deferred revenues of $100,000) | 3,000,000 |

The fund balance of Abbey’s unrestricted current funds was
   a. $1,900,000
   b. $2,000,000
   c. $2,100,000
   d. $5,000,000

45. The following receipts were among those recorded by Kery College during 1986:

| Unrestricted gifts | $500,000 |
| Restricted current funds (expended for current operating purposes) | 200,000 |
| Restricted current funds (not yet expended) | 100,000 |

The amount that should be included in current funds revenues is
   a. $800,000
   b. $700,000
   c. $600,000
   d. $500,000

46. Palma Hospital’s patient service revenues for services provided in 1986, at established rates, amounted to $8,000,000 on the accrual basis. For internal reporting, Palma uses the discharge method. Under this method, patient service revenues are recognized only when patients are discharged, with no recognition given to revenues accruing for services to patients not yet discharged. Patient service revenues at established rates using the discharge method amounted to $7,000,000 for 1986. According to generally accepted accounting principles, Palma should report patient service revenues for 1986 of
   a. Either $8,000,000 or $7,000,000, at the option of the hospital.
   b. $8,000,000
   c. $7,500,000
   d. $7,000,000

47. The following information pertains to Wood Township’s long-term debt:

   Cash accumulations to cover payment of principal and interest on
   General long-term obligations $350,000
   Proprietary fund obligations 100,000

How much of these cash accumulations should be accounted for in Wood’s debt service funds?
   a. $0
   b. $100,000
   c. $350,000
   d. $450,000

48. In 1986, Menton City received $5,000,000 of bond proceeds to be used for capital projects. Of this amount, $1,000,000 was expended in 1986. Expenditures for the $4,000,000 balance were expected to be incurred in 1987. These bond proceeds should be recorded in capital projects funds for
   a. $5,000,000 in 1986.
   b. $5,000,000 in 1987.
   c. $1,000,000 in 1986 and $4,000,000 in 1987.
   d. $1,000,000 in 1986 and in the general fund for $4,000,000 in 1986.

49. Aviary Haven, a voluntary welfare organization funded by contributions from the general public, received unrestricted pledges of $500,000 during 1986. It was estimated that 12% of these pledges would be uncollectible. By the end of 1986, $400,000 of the pledges had been collected, and it was expected that $40,000 more would be collected in 1987, with the balance of $60,000 to be written off as uncollectible. Donors did not specify any periods during which the donations were to be used. What amount should Aviary include under public support in 1986 for net contributions?
   a. $500,000
   b. $452,000
   c. $440,000
   d. $400,000
50. During 1986, Shaw Hospital purchased medicines for hospital use totaling $800,000. Included in this $800,000 was an invoice of $10,000 that was canceled in 1986 by the vendor because the vendor wished to donate this medicine to Shaw. This donation of medicine should be recorded as
   a. A $10,000 reduction of medicine expense.
   b. An increase in other operating revenue of $10,000.
   c. A direct $10,000 credit to the general (unrestricted) funds balance.
   d. A $10,000 credit to the restricted funds balance.

51. In 1986, Pyle Hospital received a $250,000 pure endowment fund grant. Also in 1986, Pyle’s governing board designated, for special uses, $300,000 which had originated from unrestricted gifts. What amount of these resources should be accounted for as part of general (unrestricted) funds?
   a. $0
   b. $250,000
   c. $300,000
   d. $350,000

52. The following proceeds were received by Kew City from specific revenue sources that are legally restricted to expenditure for specified purposes:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gasoline taxes to finance road repairs</td>
<td>$400,000</td>
</tr>
<tr>
<td>Levies on affected property owners to finance sidewalk repairs</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

The amount that should be accounted for in Kew’s special revenue funds is
   a. $0
   b. $300,000
   c. $400,000
   d. $700,000

53. Wells Township issued the following long-term obligations:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue bonds to be repaid from admission fees collected by the township swimming pool</td>
<td>$500,000</td>
</tr>
<tr>
<td>General obligation bonds issued for the township water and sewer fund which will service the debt</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

Although the above-mentioned bonds are expected to be paid from enterprise funds, the full faith and credit of Wells Township has been pledged as further assurance that the liabilities will be paid. What amount of these bonds should be accounted for in the general long-term debt account group?
   a. $1,400,000
   b. $900,000
   c. $500,000
   d. $0

54. Lake City operates a centralized data processing center through an internal service fund, to provide data processing services to Lake’s other governmental units. In 1986, this internal service fund billed Lake’s water and sewer fund $100,000 for data processing services. How should the internal service fund record this billing?

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Memorandum entry only</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>b. Due from water and sewer fund</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Data processing department expenses</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>$100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Intergovernmental transfers</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Interfund exchanges</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>$100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Due from water and sewer fund</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Operating revenues control</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>$100,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

55. Burr City has approved a special assessment project providing for total assessments of $300,000, to be collected from affected property owners in five equal annual installments starting in 1987. The entry to be made to record the levy of assessments in 1987 is

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Special assessments receivable</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>— current</td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td>Special assessments receivable</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>— deferred</td>
<td>$240,000</td>
<td></td>
</tr>
<tr>
<td>Revenues control</td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td>Deferred revenues</td>
<td></td>
<td>$240,000</td>
</tr>
<tr>
<td>b. Special assessments receivable</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>— current</td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td>Revenues control</td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td>Deferred revenues</td>
<td></td>
<td>$60,000</td>
</tr>
<tr>
<td>c. Special assessments receivable</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>$300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues control</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Deferred revenues</td>
<td></td>
<td>$300,000</td>
</tr>
<tr>
<td>d. Special assessments receivable</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>$300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues control</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Deferred revenues</td>
<td></td>
<td>$300,000</td>
</tr>
</tbody>
</table>

56. Dodd Village received a gift of a new fire engine from a local resident. The fair market value of this fire engine was $200,000. The entry to be made in the general fixed assets account group for this gift is

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Machinery and equipment</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Investment in general fixed assets</td>
<td>$200,000</td>
<td></td>
</tr>
<tr>
<td>from private gifts</td>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td>b. Investment in general fixed assets</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Gift revenue</td>
<td>$200,000</td>
<td></td>
</tr>
<tr>
<td>$200,000</td>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td>c. General fund assets</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Private gifts</td>
<td>$200,000</td>
<td></td>
</tr>
<tr>
<td>$200,000</td>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td>d. Memorandum entry only</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

N-21
Examination Questions — November 1987

Items 57 and 58 are based on the following information pertaining to the sale of equipment by Nous Foundation, a voluntary health and welfare organization:

<table>
<thead>
<tr>
<th>Items</th>
<th>Description</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales price</td>
<td></td>
<td>12,000</td>
</tr>
<tr>
<td>Cost</td>
<td></td>
<td>14,000</td>
</tr>
<tr>
<td>Carrying amount</td>
<td></td>
<td>10,000</td>
</tr>
</tbody>
</table>

Nous made the correct entry to record the $2,000 gain on sale.

57. The additional entry that Nous should record in connection with this sale is

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Fund balance — expended</td>
<td>Fund balance — unexpended</td>
</tr>
<tr>
<td>b. Fund balance — unexpended</td>
<td>Fund balance — expended</td>
</tr>
<tr>
<td>c. Excess revenues control</td>
<td>Sale of equipment</td>
</tr>
<tr>
<td>d. Current unrestricted funds</td>
<td>Fund balance — undesignated</td>
</tr>
</tbody>
</table>

58. The amount that should be debited and credited for the additional entry in connection with this sale is

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>2,000</td>
</tr>
<tr>
<td>b.</td>
<td>10,000</td>
</tr>
<tr>
<td>c.</td>
<td>12,000</td>
</tr>
<tr>
<td>d.</td>
<td>14,000</td>
</tr>
</tbody>
</table>

Number 4 (Estimated time — 45 to 55 minutes)

Webb & Company is engaged in the preparation of income tax returns for individuals. Webb uses the weighted average method and actual costs for financial reporting purposes. However, for internal reporting, Webb uses a standard cost system. The standards, based on equivalent performance, have been established as follows:

- Labor per return: 5 hrs. @ $20 per hr.
- Overhead per return: 5 hrs. @ $10 per hr.

For March 1987 performance, budgeted overhead is $49,000 for the standard labor hours allowed. The following additional information pertains to the month of March 1987:

Inventory data

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns in process, March 1 (25% complete)</td>
<td>200</td>
</tr>
<tr>
<td>Returns started in March</td>
<td>825</td>
</tr>
<tr>
<td>Returns in process, March 31 (80% complete)</td>
<td>125</td>
</tr>
</tbody>
</table>

Actual cost data

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns in process March 1:</td>
<td></td>
</tr>
<tr>
<td>Labor</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Overhead</td>
<td>2,500</td>
</tr>
<tr>
<td>Labor, March 1 to 31</td>
<td>89,000</td>
</tr>
<tr>
<td>4,000 hours</td>
<td></td>
</tr>
<tr>
<td>Overhead, March 1 to 31</td>
<td>45,000</td>
</tr>
</tbody>
</table>

Required:

a. Using the weighted average method, compute the following for each cost element:

1. Equivalent units of performance.
2. Actual cost per equivalent unit.

b. Compute the actual cost of returns in process at March 31.

c. Compute the standard cost per return.

d. Prepare a schedule for internal reporting analyzing March performance, using the following variances, and indicating whether the variances are favorable or unfavorable:

1. Total labor.
2. Labor rate.
3. Labor efficiency.
4. Total overhead.
5. Overhead volume.

59. The following funds are among those maintained by Arlon City:

<table>
<thead>
<tr>
<th>Funds</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprise funds</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Internal service funds</td>
<td>800,000</td>
</tr>
</tbody>
</table>

Arlon's proprietary funds amount to

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>0</td>
</tr>
<tr>
<td>b.</td>
<td>800,000</td>
</tr>
<tr>
<td>c.</td>
<td>2,000,000</td>
</tr>
<tr>
<td>d.</td>
<td>2,800,000</td>
</tr>
</tbody>
</table>

60. Payne Hospital received an unrestricted bequest of $100,000 in 1986. This bequest should be recorded as

a. A memorandum entry only.
b. Other operating revenue of $100,000.
c. Nonoperating revenue of $100,000.
d. A direct credit of $100,000 to the fund balance.

N-22
The December 31, 1986 condensed balance sheets of Pym Corp. and its 90%-owned subsidiary, Sy Corp., are presented in the tear-out worksheet.

Additional information follows:

- Pym's investment in Sy was purchased for $1,200,000 cash on January 1, 1986, and is accounted for by the equity method.

- At January 1, 1986, Sy's retained earnings amounted to $600,000, and its common stock amounted to $200,000.

- Sy declared a $1,000 cash dividend in December 1986, payable in January 1987.

- As of December 31, 1986, Pym had not recorded any portion of Sy's 1986 net income or dividend declaration.

- Sy borrowed $100,000 from Pym on June 30, 1986, with the note maturing on June 30, 1987, at 10% interest. Correct accruals have been recorded by both companies.

- During 1986, Pym sold merchandise to Sy at an aggregate invoice price of $300,000, which included a profit of $60,000. At December 31, 1986, Sy had not paid Pym for $90,000 of these purchases, and 5% of the total merchandise purchased from Pym still remained in Sy's inventory.

- Pym's excess cost over book value of Pym's investment in Sy has appropriately been identified as goodwill and is to be amortized over 10 years.

Required:

Complete the tear-out worksheet for Pym Corp. and its subsidiary, Sy Corp., at December 31, 1986.

A formal consolidated balance sheet and journal entries are not required. Include the completed tear-out worksheet in the proper sequence with your other answer sheets.
### Consolidated Balance Sheet Worksheet

**December 31, 1986**

<table>
<thead>
<tr>
<th></th>
<th>Pym Corp.</th>
<th>Sy Corp.</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>75,000</td>
<td>15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts and other current receivables</td>
<td>410,000</td>
<td>120,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>920,000</td>
<td>670,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant and equipment (net)</td>
<td>1,000,000</td>
<td>400,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Sy Corp.</td>
<td>1,200,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>3,605,000</td>
<td>1,205,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Liabilities and Stockholders' Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and other current liabilities</td>
<td>140,000</td>
<td>305,000</td>
<td></td>
<td></td>
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<tr>
<td>Common stock ($10 par)</td>
<td>500,000</td>
<td>200,000</td>
<td></td>
<td></td>
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<tr>
<td>Retained earnings</td>
<td>2,965,000</td>
<td>700,000</td>
<td></td>
<td></td>
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<tr>
<td><strong>Totals</strong></td>
<td>3,605,000</td>
<td>1,205,000</td>
<td></td>
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</tr>
</tbody>
</table>
EXAMINATION IN AUDITING

November 5, 1987; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
<th>Point Value</th>
<th>Minimum</th>
<th>Maximum</th>
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<tr>
<td>Total</td>
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<td>100</td>
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</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 may 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 controls.
   d. Count client petty cash funds.

**Answer Sheet**

96.  a  b  •  d

Items to be Answered

1. An auditor has been asked to report on the balance sheet of Kane Company but not on the other basic financial statements. The auditor will have access to all information underlying the basic financial statements. Under these circumstances, the auditor
   a. May accept the engagement because such engagements merely involve limited reporting objectives.
   b. May accept the engagement but should disclaim an opinion because of an inability to apply the procedures considered necessary.
   c. Should refuse the engagement because there is a client-imposed scope limitation.
   d. Should refuse the engagement because of a departure from generally accepted auditing standards.

2. When a question arises about an entity’s continued existence, the auditor should consider factors tending to mitigate the significance of contrary information concerning the entity’s alternative means for maintaining adequate cash flow. An example of such a factor is the
   a. Possibility of purchasing certain assets rather than leasing them.
   b. Capability of extending the due dates of existing loans.
   c. Feasibility of operating at increased levels of production.
   d. Marketability of property and equipment that management plans to keep.

3. For which of the following events would the auditor appropriately issue a report that contains the standard phrase concerning consistency?
   a. A change in the percentage used to calculate the provision for warranty expense.
   b. Correction of a mistake in the application of a generally accepted accounting principle.
   c. A change in the method of accounting for specific subsidiaries that constitute the group of companies for which consolidated statements are presented.
   d. A change from an accounting principle that is not generally accepted to one that is generally accepted.

4. The objective of auditing procedures applied to segment information is to provide the auditor with a reasonable basis for concluding whether
   a. The information is useful for comparing a segment of one enterprise with a similar segment of another enterprise.
   b. Sufficient evidential matter has been obtained to allow the auditor to be associated with the segment information.
   c. A separate opinion on the segment information is necessary due to inconsistent application of accounting principles.
   d. The information is presented in conformity with the FASB Statement on segment information in relation to the financial statements taken as a whole.

5. The prior year’s financial statements of YZ, Inc., which were audited by Pate, CPA, are presented for comparative purposes without Pate’s audit report. Jennings, CPA, the successor auditor, should indicate in the current year audit report that the prior year’s financial statements were examined by another auditor
   a. Only if Pate’s opinion was other than unqualified.
   b. But should not indicate the type of opinion expressed by Pate.
   c. Only if the prior year’s financial statements have been restated.
   d. But should not name Pate as the predecessor auditor.

6. An auditor who is determining the scope of work to be performed concerning possible related party transactions should
   a. Assume that transactions with related parties are outside the ordinary course of business.
   b. Determine whether transactions with related parties would have taken place if the parties had not been related.
   c. Obtain an understanding of management responsibilities and the relationship of each of the parties to the total entity.
   d. Establish a basis of accounting principles different from that which would have been appropriate had the parties not been related.
7. Financial statements compiled without audit or review by an accountant should be accompanied by a report stating that
   a. The financial statements have not been audited or reviewed and, accordingly, the accountant expresses only limited assurance on them.
   b. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
   c. The accountant is not aware of any material modifications that should be made to the financial statements for them to conform with generally accepted accounting principles.
   d. A compilation is less in scope than a review, and substantially less in scope than an examination in accordance with generally accepted auditing standards.

8. If the auditor believes that financial statements prepared on the entity's income tax basis are not suitably titled, the auditor should
   a. Issue a disclaimer of opinion.
   b. Explain in the notes to the financial statements the terminology used.
   c. Issue a compilation report.
   d. Modify the auditor's report to disclose any reservations.

9. An auditor's report on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles should include all of the following except
   a. Reference to the note to the financial statements that describes how the basis of preparation differs from generally accepted accounting principles.
   b. Disclosure of the fact that the financial statements are not intended to be presented in conformity with generally accepted accounting principles.
   c. An opinion as to whether the basis of accounting used is appropriate under the circumstances.
   d. An opinion as to whether the financial statements are presented fairly in conformity with the basis of accounting described.

10. When third party use of prospective financial statements is expected, an accountant may not accept an engagement to
    a. Perform a review.
    b. Perform a compilation.
    c. Perform an examination.
    d. Apply agreed-upon procedures.

11. Which of the following is a prospective financial statement for general use upon which an accountant may appropriately report?
    a. Financial projection.
    b. Partial presentation.
    c. Pro forma financial statement.
    d. Financial forecast.

12. The party responsible for assumptions identified in the preparation of prospective financial statements is usually
    a. A third-party lending institution.
    b. The client's management.
    c. The reporting accountant.
    d. The client's independent auditor.

13. In which of the following reports should an accountant not express negative or limited assurance?
    a. A standard review report on financial statements of a nonpublic entity.
    b. A standard compilation report on financial statements of a nonpublic entity.
    c. A standard comfort letter on financial information included in a registration statement of a public entity.
    d. A standard review report on interim financial statements of a public entity.

14. Baker, the continuing auditor of AC Resources, a publicly held company, has been requested to report on the system of internal accounting control. The report is to be based solely on the study and evaluation of internal accounting control that Baker made in the audit of AC's financial statements, even though the study and evaluation is not sufficient for expressing an opinion on the system taken as a whole. Baker intends to describe the limited purpose of the study and evaluation and to disclaim an opinion on the system taken as a whole. In these circumstances, Baker
    a. May report provided the report indicates it is intended solely for management or other specified parties.
    b. May report provided the report is included with the basic financial statements distributed to the stockholders.
    c. May not report because there is no basis for determining whether material errors or irregularities may occur and be detected.
    d. May not report because it would be a violation of generally accepted auditing standards.

15. Which of the following statements is correct regarding the auditor's responsibilities for supplementary information required by the FASB?
    a. Because the supplementary information is a required part of the basic financial statements, the auditor should apply normal auditing procedures.
    b. The omission of, but not deficiencies in, supplementary information should be disclosed in the opinion paragraph of the auditor's report.
    c. Because the supplementary information is not a required part of the basic financial statements, the auditor should apply only certain limited procedures.
    d. The omission of supplementary information ordinarily requires the auditor to issue an adverse opinion, but mere deficiencies require an “except for” qualified opinion.
16. A flowchart is most frequently used by an auditor in connection with the
   a. Preparation of generalized computer audit programs.
   b. Review of the client’s internal accounting controls.
   c. Use of statistical sampling in performing an audit.
   d. Performance of analytical review procedures of account balances.

17. Audits of certain governmental entities are required to be performed in accordance with generally accepted government auditing standards (GAGAS). These standards do not require, as part of an auditor’s report, the identification of
   a. Significant internal accounting and administrative controls designed to provide reasonable assurance that federal programs are being administered in compliance with applicable laws and regulations.
   b. Material weaknesses discovered as a result of the study and evaluation of the internal control systems.
   c. Sampling methods used to test the internal controls designed to detect errors and irregularities.
   d. Significant internal accounting and administrative controls that were not evaluated, and the reasons why they were not evaluated.

18. If requested to perform a review engagement for a nonpublic entity in which an accountant has an immaterial direct financial interest, the accountant is
   a. Not independent and, therefore, may issue a review report, but may not issue an auditor’s opinion.
   b. Not independent and, therefore, may not issue a review report.
   c. Not independent and, therefore, may not be associated with the financial statements.
   d. Independent because the financial interest is immaterial and, therefore, may issue a review report.

19. An auditor strives to achieve independence in appearance in order to
   a. Maintain public confidence in the profession.
   b. Become independent in fact.
   c. Comply with the generally accepted auditing standards of field work.
   d. Maintain an unbiased mental attitude.

20. In planning a new engagement, which of the following is not a factor that affects the auditor’s judgment as to the quantity, type, and content of working papers?
   a. The auditor’s estimated occurrence rate of attributes.
   b. The auditor’s preliminary evaluations of risk based on discussions with the client.
   c. The content of the client’s representation letter.
   d. The type of report to be issued by the auditor.

21. According to the AICPA Code of Professional Ethics, may a CPA who is in partnership with non-CPAs sign a report with the firm name and below it affix the CPA’s own signature with the designation ‘‘Certified Public Accountant’’?
   a. No, because a CPA should not form a partnership with non-CPAs.
   b. No, because it would appear that all partners were associated with the report when only one actually is associated.
   c. Yes, provided the non-CPA partners adhere to the professional standards concerning quality control.
   d. Yes, provided it is clear that the partnership itself is not being held out as composed entirely of CPAs.

22. Which one of the following is an enforceable set of pronouncements of an authoritative body designated to establish accounting principles, according to the AICPA Code of Professional Ethics?
   a. AICPA Statements on Standards for Accounting and Review Services.
   b. AICPA Statements of Position.
   c. FASB Interpretations.

23. The risk that an auditor’s procedures will lead to the conclusion that a material error does not exist in an account balance when, in fact, such error does exist is referred to as
   a. Audit risk.
   b. Inherent risk.
   c. Control risk.
   d. Detection risk.

24. Because an examination in accordance with generally accepted auditing standards is influenced by the possibility of material errors, the auditor should conduct the examination with an attitude of
   a. Professional responsiveness.
   b. Conservative advocacy.
   c. Objective judgment.
   d. Professional skepticism.

25. With respect to errors and irregularities, the auditor should plan to
   a. Search for errors that would have a material effect and for irregularities that would have either material or immaterial effect on the financial statements.
   b. Search for irregularities that would have a material effect and for errors that would have either material or immaterial effect on the financial statements.
   c. Search for errors or irregularities that would have a material effect on the financial statements.
   d. Discover errors or irregularities that have either material or immaterial effect on the financial statements.
26. The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the
a. Methods of statistical sampling to be used in confirming accounts receivable.
 b. Pending legal matters to be included in the inquiry of the client’s attorney.
 c. Evidence to be gathered to provide a sufficient basis for the auditor’s opinion.
 d. Schedules and analyses to be prepared by the client’s staff.

27. As lower acceptable levels of both audit risk and materiality are established, the auditor should plan more work on individual accounts to
a. Find smaller errors.
 b. Find larger errors.
 c. Increase the tolerable error in the accounts.
 d. Decrease the risk of overreliance.

28. The most likely explanation why the auditor’s examination cannot reasonably be expected to bring all illegal acts by the client to the auditor’s attention is that
a. Illegal acts are perpetrated by management override of internal accounting controls.
 b. Illegal acts by clients often relate to operating aspects rather than accounting aspects.
 c. The client’s system of internal accounting control may be so strong that the auditor performs only minimal substantive testing.
 d. Illegal acts may be perpetrated by the only person in the client’s organization with access to both assets and the accounting records.

29. A CPA should not submit unaudited financial statements of a nonpublic company to a client or others unless, as a minimum, the CPA complies with the provisions applicable to
a. Compilation engagements.
 b. Review engagements.
 c. Statements on auditing standards.
 d. Attestation standards.

30. The underwriter of a securities offering may request that an auditor perform specified procedures and supply certain assurances concerning unaudited information contained in a registration statement. The auditor’s response to such a request is commonly called a
a. Report under federal security statutes.
 b. Comfort letter.
 c. Review of interim financial information.
 d. Compilation report for underwriters.

31. An audit working paper that reflects the major components of an amount reported in the financial statements is referred to as a(an)
a. Lead schedule.
b. Supporting schedule.
c. Audit control account.
d. Working trial balance.

32. When considering the use of management’s written representations as audit evidence about the completeness assertion, an auditor should understand that such representations
a. Complement, but do not replace, substantive tests designed to support the assertion.
b. Constitute sufficient evidence to support the assertion when considered in combination with reliance on internal accounting controls.
c. Are not part of the evidential matter considered to support the assertion.
d. Replace reliance on internal accounting controls as evidence to support the assertion.

33. One reason why an auditor makes an analytical review of the client’s operations is to identify
a. Improper separation of accounting and other financial duties.
b. Weaknesses of a material nature in the system of internal accounting control.
c. Unusual transactions.
d. Non-compliance with prescribed control procedures.

34. After accounting for a sequence of inventory tags, an auditor traces a sample of tags to the physical inventory listing to obtain evidence that all items
a. Included in the listing have been counted.
b. Represented by inventory tags are included in the listing.
c. Included in the listing are represented by inventory tags.
d. Represented by inventory tags are bona fide.

35. Which of the following statements ordinarily is included among the written client representations obtained by the auditor?
a. Sufficient evidential matter has been made available to permit the issuance of an unqualified opinion.
b. Compensating balances and other arrangements involving restrictions on cash balances have been disclosed.
c. Management acknowledges responsibility for illegal actions committed by employees.
d. Management acknowledges that there are no material weaknesses in internal accounting controls.

36. An attorney responding to an auditor as a result of the client’s letter of audit inquiry may appropriately limit the response to
a. Items which have high probability of being resolved to the client’s detriment.
b. Asserted claims and pending or threatened litigation.
c. Legal matters subject to unsettled points of law, uncorroborated information, or other complex judgments.
d. Matters to which the attorney has given substantive attention in the form of legal consultation or representation.
37. An auditor’s program for the examination of long-term debt should include steps that require the
   a. Inspection of the accounts payable subsidiary ledger.
   b. Investigation of credits to the bond interest income account.
   c. Verification of the existence of the bondholders.
   d. Examination of any bond trust indenture.

38. Hill has decided to use Probability Proportional to Size (PPS) sampling, sometimes called dollar-unit sampling, in the audit of a client’s accounts receivable balances. Hill plans to use the following PPS sampling table:

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<td><strong>Reliability Factors for Errors of Overstatement</strong></td>
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<th>Number of overstatement errors</th>
<th>Risk of Incorrect Acceptance</th>
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<td>11.61</td>
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**Additional Information**

Tolerable error
(net of effect of expected error) ............ $24,000
Risk of incorrect acceptance ................. 20%
Number of errors allowed ..................... 1
Recorded amount of accounts receivable ... $240,000
Number of accounts ........................... 360

What sample size should Hill use?
   a. 120
   b. 108
   c. 60
   d. 30

39. While substantive tests may support the accuracy of underlying records, these tests frequently provide no affirmative evidence of segregation of duties because
   a. Substantive tests rarely guarantee the accuracy of the records if only a sample of the transactions has been tested.
   b. The records may be accurate even though they are maintained by persons having incompatible functions.
   c. Substantive tests relate to the entire period under audit, but compliance tests ordinarily are confined to the period during which the auditor is on the client’s premises.
   d. Many computerized procedures leave no audit trail of who performed them, so substantive tests may necessarily be limited to inquiries and observation of office personnel.

40. An accountant has been asked to issue a review report on the balance sheet of a nonpublic company but not to report on the other basic financial statements. The accountant may not do so
   a. Because compliance with this request would result in an incomplete review.
   b. Because compliance with this request would result in a violation of the ethical standards of the profession.
   c. If the scope of the inquiry and analytical procedures has been restricted.
   d. If the review of the balance sheet discloses material departures from generally accepted accounting principles.

41. Inquiry and analytical procedures ordinarily performed during a review of a nonpublic entity’s financial statements include
   a. Analytical procedures designed to identify material weaknesses in internal accounting control.
   b. Inquiries concerning actions taken at meetings of the stockholders and the board of directors.
   c. Analytical procedures designed to test the accounting records by obtaining corroborating evidential matter.
   d. Inquiries of knowledgeable outside parties such as the client’s attorneys and bankers.

42. The use of fidelity bonds may indemnify a company from embezzlement losses. The use also
   a. Reduces the company’s need to obtain expensive business interruption insurance.
   b. Protects employees who made unintentional errors from possible monetary damages resulting from such errors.
   c. Allows the company to substitute the fidelity bonds for various parts of internal accounting control.
   d. Reduces the possibility of employing persons with dubious records in positions of trust.

43. An auditor evaluates the existing system of internal accounting control primarily to
   a. Ascertain whether errors and irregularities exist.
   b. Determine the extent of compliance testing that should be performed.
   c. Determine the extent of substantive testing that should be performed.
   d. Make constructive suggestions to the client for improvement.

44. An auditor is least likely to test for compliance with the internal accounting control that provides for
   a. Segregation of the functions of recording disbursements and reconciling the bank account.
   b. Comparison of receiving reports and vendors’ invoices with purchase orders.
   c. Approval of the purchase and sale of marketable securities.
   d. Classification of revenue and expense transactions by product line.

N-30
45. An auditor's purpose for performing compliance testing is to provide reasonable assurance that
   a. The controls on which the auditor plans to rely are being applied as perceived during the preliminary evaluation.
   b. The risk that the auditor may unknowingly fail to modify the opinion on the financial statements is minimized.
   c. Transactions are executed in accordance with management's authorization and access to assets is limited by a segregation of functions.
   d. Transactions are recorded as necessary to permit the preparation of the financial statements in conformity with generally accepted accounting principles.

46. A conceptually logical approach to the auditor's evaluation of internal accounting control consists of the following four steps:
   I. Determine whether the necessary procedures are prescribed and are being followed satisfactorily.
   II. Consider the types of errors and irregularities that could occur.
   III. Determine the internal accounting control procedures that should prevent or detect errors and irregularities.
   IV. 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.

What should be the order in which these four steps are performed?
   a. III, IV, I, II
   b. III, I, II, IV
   c. II, III, I, IV
   d. II, I, III, IV

47. The most likely result of ineffective internal accounting controls in the revenue cycle is that
   a. Fictitious transactions could be recorded, causing an understatement of revenues and overstatement of receivables.
   b. Irregularities in recording transactions in the subsidiary accounts could result in a delay in goods shipped.
   c. Omission of shipping documents could go undetected, causing an understatement of inventory.
   d. Final authorization of credit memos by personnel in the sales department could permit an employee defalcation scheme.

48. An auditor generally tests physical security controls over inventory by
   a. Test counts and cutoff procedures.
   b. Examination and reconciliation.
   c. Inspection and recomputation.
   d. Inquiry and observation.

49. CPA firms should establish quality control policies and procedures for professional development in order to provide reasonable assurance that
   a. Employees promoted possess the appropriate characteristics to perform competently.
   b. Personnel will have the knowledge required to fulfill responsibilities assigned.
   c. The extent of supervision and review in a given instance will be appropriate.
   d. Association with a client whose management lacks integrity will be minimized.

50. Which of the following internal accounting control procedures would most likely allow for a reduction in the scope of the auditor’s tests of depreciation expense?
   a. Review and approval of the periodic equipment depreciation entry by a supervisor who does not actively participate in its preparation.
   b. Comparison of equipment account balances for the current year with the current-year budget and prior-year actual balances.
   c. Review of the miscellaneous income account for salvage credits and scrap sales of partially depreciated equipment.
   d. Authorization of payment of vendors’ invoices by a designated employee who is independent of the equipment receiving function.

51. Which of the following statements is correct concerning the auditor’s required communication of material weaknesses in internal accounting control?
   a. If the auditor does not become aware of any material weaknesses during the examination, that fact must be communicated.
   b. Weaknesses reported at interim dates should be tested for correction before completion of the engagement.
   c. Although written communication is preferable, the auditor may communicate the findings orally.
   d. Weaknesses reported at interim dates must be repeated in the communication at the completion of the engagement.

52. The accountant's report expressing an opinion on an entity's system of internal accounting control should state that the
   a. Study and evaluation of the system of internal accounting control was conducted in accordance with generally accepted auditing standards.
   b. Establishment and maintenance of the system of internal accounting control are the responsibilities of management.
   c. Inherent limitations of any system of internal accounting control may prevent the preparation of financial statements in accordance with generally accepted accounting principles.
   d. Client's management has provided assurance that the expected benefits of the internal accounting control procedures are in excess of their related costs.
Examination Questions — November 1987

53. For the most effective internal accounting control, monthly bank statements should be received directly from the banks and reviewed by the
a. Controller.
b. Cash receipts accountant.
c. Cash disbursements accountant.
d. Internal auditor.

54. An auditor would consider internal accounting control over a client's payroll procedures to be ineffective if the payroll department supervisor is responsible for
a. Hiring subordinate payroll department employees.
b. Having custody over unclaimed paychecks.
c. Updating employee earnings records.
d. Applying pay rates to time tickets.

55. Which of the following departments should have the responsibility for authorizing payroll rate changes?
   a. Personnel.
   b. Payroll.
   c. Treasurer.
   d. Timekeeping.

56. An auditor selects a sample from the file of shipping documents to determine whether invoices were prepared. This test is performed to satisfy the audit objective of
   a. Accuracy.
   b. Completeness.
   c. Control.
   d. Existence.

57. When assessing the tolerable rate, the auditor should consider that, while deviations from control procedures increase the risk of material errors, such deviations do not necessarily result in errors. This explains why
   a. A recorded disbursement that does not show evidence of required approval may nevertheless be a transaction that is properly authorized and recorded.
   b. Deviations would result in errors in the accounting records only if the deviations and the errors occurred on different transactions.
   c. Deviations from pertinent control procedures at a given rate ordinarily would be expected to result in errors at a higher rate.
   d. A recorded disbursement that is properly authorized may nevertheless be a transaction that contains a material error.

58. The expected population deviation rate of client billing errors is 3%. The auditor has established a tolerable rate of 5%. In the review of client invoices the auditor should use
   a. Stratified sampling.
   b. Variable sampling.
   c. Discovery sampling.
   d. Attribute sampling.

59. The risk of incorrect acceptance and the risk of over-reliance on internal accounting control relate to the
   a. Preliminary estimates of materiality levels.
   b. Allowable risk of tolerable error.
   c. Efficiency of the audit.
   d. Effectiveness of the audit.

60. When audited financial statements are presented in a document containing other information, the auditor
   a. Has an obligation to perform auditing procedures to corroborate the other information.
   b. Is required to issue an "except for" qualified opinion if the other information has a material misstatement of fact.
   c. Should read the other information to consider whether it is inconsistent with the audited financial statements.
   d. Has no responsibility for the other information because it is not part of the basic financial statements.

Number 2 (Estimated time — 15 to 25 minutes)

Green, CPA, has been engaged to audit the financial statements of Star Manufacturing, Inc. Star is a medium-sized entity that produces a wide variety of household goods. All acquisitions of materials are processed through the purchasing, receiving, accounts payable, and treasury functions.

Required:

Prepare the "Purchases" segment of the internal accounting control questionnaire to be used in the evaluation of Star's internal accounting control system. Each question should elicit either a yes or no response.

Do not prepare the receiving, accounts payable, or treasury segments of the internal accounting control questionnaire.

Do not discuss the internal accounting controls over purchases.

Number 3 (Estimated time — 15 to 25 minutes)

MLG Company's auditor received directly from the banks, confirmations and cut-off statements with related checks and deposit tickets for MLG's three general-purpose bank accounts. The auditor determined that internal accounting control over cash was satisfactory and will be relied upon. The proper cut-off of external cash receipts and disbursements was established. No bank accounts were opened or closed during the year.

Required:

Prepare the audit program of substantive procedures to verify MLG's bank balances. Ignore any other cash accounts.
Auditing

Number 4 (Estimated time —— 15 to 25 minutes)

Microcomputer software has been developed to improve the efficiency and effectiveness of the audit. Electronic spreadsheets and other software packages are available to aid in the performance of audit procedures otherwise performed manually.

Required:

Describe the potential benefits to an auditor of using microcomputer software in an audit as compared to performing an audit without the use of a computer.

Number 5 (Estimated time —— 15 to 25 minutes)

The auditor’s standard report consists of a statement describing the nature of the examination, usually in an opening “scope” paragraph, and an expression of the auditor’s opinion, usually in a closing “opinion” paragraph. There are circumstances where the auditor’s standard report is modified by adding one or more separate explanatory paragraphs, and/or modifying the wording of the scope paragraph or opinion paragraph.

For purposes of this question, assume the auditor is independent and has previously expressed an unqualified opinion on the prior year’s financial statements. For the current year, only single-year (not comparative) statements are presented.

Required:

Identify the circumstances necessitating modification of the auditor’s standard report. For each circumstance indicate the types of opinion that would be appropriate and describe the report modifications.

Organize the answer as indicated in the following example:

<table>
<thead>
<tr>
<th>Circumstances</th>
<th>Type of Opinion</th>
<th>Report Modification</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The financial statements are materially affected by a departure from generally accepted accounting principles.</td>
<td>1. The auditor should express an “except for” qualified opinion or an adverse opinion.</td>
<td>1. The auditor should explain the basis and effects of the departure in an explanatory paragraph and modify the opinion paragraph.</td>
</tr>
</tbody>
</table>
EXAMINATION IN BUSINESS LAW

(Commercial Law)

November 6, 1987; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
<th>Value</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 1</td>
<td>.................................</td>
<td>60</td>
<td>110</td>
<td>130</td>
</tr>
<tr>
<td>No. 2</td>
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<td>10</td>
<td>15</td>
<td>20</td>
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<td>No. 3</td>
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<td>No. 4</td>
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<td>No. 5</td>
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<tr>
<td>Total</td>
<td>.................................</td>
<td>100</td>
<td>170</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 may 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.
Business Law

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. On June 1, 1986, Nord Corp. engaged Milo & Co., CPAs, to perform certain management advisory services for nine months for a $45,000 fee. The terms of their oral agreement required Milo to commence performance any time before October 1, 1986. On June 30, 1987, after Milo completed the work to Nord's satisfaction, Nord paid Milo $30,000 by check. Nord conspicuously marked on the check that it constituted payment in full for all services rendered. Nord has refused to pay the remaining $15,000 arguing that, although it believes the $45,000 fee is reasonable, it had received bids of $30,000 and $38,000 from other firms to perform the same services as Milo. Milo endorsed and deposited the check. If Milo commences an action against Nord for the remaining $15,000, Milo will be entitled to recover

a. $0 because there has been an enforceable accord and satisfaction.

b. $0 because the statute of frauds has not been satisfied.

c. $8,000 because $38,000 was the highest other bid.

d. $15,000 because it is the balance due under the agreement.

2. Blue purchased a travel agency business from Drye. The purchase price included payment for Drye's goodwill. The agreement contained a covenant prohibiting Drye from competing with Blue in the travel agency business. Which of the following statements regarding the covenant is not correct?

a. The restraint must be no more extensive than is reasonably necessary to protect the goodwill purchased by Blue.

b. The geographic area to which it applies must be reasonable.

c. The time period for which it is to be effective must be reasonable.

d. The value to be assigned to it is the excess of the price paid over the seller's cost of all tangible assets.

3. With regard to an agreement for the sale of real estate, the statute of frauds

a. Requires that the entire agreement be in a single writing.

b. Requires that the purchase price be fair and adequate in relation to the value of the real estate.

c. Does not require that the agreement be signed by all parties.

d. Does not apply if the value of the real estate is less than $500.

4. Sisk contracted to sell Bleu a building for $470,000. If Sisk wishes to avoid the contract based on undue influence, one element that Sisk must prove is that Bleu

a. Induced Sisk to sell the building by unfair persuasion.

b. Was in a fiduciary relationship with Sisk.

c. Misrepresented material facts to Sisk.

d. Made improper threats to Sisk.

5. Park entered into a contract to sell Reed a parcel of land. Park was aware that Reed was purchasing the land with the intention of building a high-rise office building. Park 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. Park did not disclose the existence of the condition to Reed, nor did Reed make any inquiry of Park as to the suitability of the land for the intended development. Park's silence as to the soil condition

a. Renders the contract voidable at Reed's option.

b. Entitles Reed only to money damages.

c. Renders the contract void.

d. Does not affect the validity of the contract.

6. In general, which of the following is least likely to be considered a security under the Securities Act of 1933?

a. General partnership interests.

b. Warrants.

c. Limited partnership interests.

d. Treasury stock.
7. One of the elements necessary to recover damages if there has been a material misstatement in a registration statement filed pursuant to the Securities Act of 1933 is that the
   a. Issuer and plaintiff be in privity of contract with each other.
   b. Issuer failed to exercise due care in connection with the sale of the securities.
   c. Plaintiff suffered a loss.
   d. Plaintiff gave value for the security.

8. After the filing of the registration statement with the SEC but prior to the effective date, the underwriter is allowed to do which of the following?
   I. Make oral offers to sell the security.
   II. Issue a preliminary prospectus ("red herring").
      a. I only.
      b. II only.
      c. I and II.
      d. Neither I nor II.

9. Rey Corp.'s management intends to solicit proxies relating to its annual meeting at which directors will be elected. Rey is subject to the registration and reporting requirements of the Securities Exchange Act of 1934. As a result, Rey must furnish its shareholders with
   a. A copy of its registration statement and bylaws.
   b. A preliminary copy of its proxy statement at the same time it is filed with the SEC.
   c. An annual report containing its audited statements of income for the five most recent years.
   d. An annual report containing its audited balance sheets for the two most recent years.

10. Pix is offering to issue $10 million of its securities pursuant to Regulation D of the Securities Act of 1933. Under the applicable provisions of Regulation D,
    a. Each investor must be an accredited investor.
    b. Pix may make a general solicitation in connection with the offering.
    c. The securities may be debentures.
    d. Pix must be a corporation.

11. Harp Corp. is offering to issue $450,000 of its securities pursuant to Regulation D of the Securities Act of 1933. Harp is not required to deliver a disclosure document in the states where the offering is being conducted. The exemption for small issues of $500,000 or less (Rule 504) under Regulation D
    a. Requires that the issuer be subject to the reporting requirements of the Securities Exchange Act of 1934.
    b. Does not require that any specific information be furnished to investors.
    c. Permits the use of general solicitation.
    d. Requires that each investor be a sophisticated investor or be represented by a purchaser representative.

   a. Apply only to issuers, underwriters, and dealers.
   b. Apply to a corporation that registered under the Securities Act of 1933 but that did not register under the Securities Exchange Act of 1934.
   c. Require all corporations engaged in interstate commerce to file an annual report.
   d. Require all corporations engaged in interstate commerce to file quarterly audited financial statements.

Items 13 and 14 are based on the following information:

During the calendar year 1987, Nix estimates having $5,000 of gross earnings from self-employment and $4,800 of allowable deductions attributable to such income. Nix expects to earn the self-employment income as a sole proprietor rendering management advisory services.

13. For this question only, if Nix receives in 1987 wages of $40,000 as an employee of Pace Corp., the amount of self-employment earnings subject to social security taxes would be
    a. $0
    b. $ 200
    c. $3,800
    d. $5,000

14. For this question only, if Nix receives in 1987 wages of $5,000, the amount of self-employment earnings subject to the federal unemployment tax would be
    a. $0
    b. $ 200
    c. $3,800
    d. $5,000

15. In general, which of the following is not an available method of complying with a state's workers' compensation statute for a private employer?
    a. Self-insurance by the employer.
    b. Participation in the state insurance fund.
    c. Participation in a federal insurance fund.
    d. Purchase of insurance from a private insurer.

16. On June 16, 1987, Eble placed 800 shares of Singh Corp.'s common stock in a trust for the benefit of Eble's child. On June 1, 1987, Singh's board of directors had declared a cash dividend of $2 per share on Singh's common stock. Payment was made on July 30, 1987 to shareholders of record on June 30, 1987. What amount of the dividend should be allocated to trust income?
    a. $0
    b. $ 800
    c. $1,200
    d. $1,600
Business Law

Items 17 and 18 are based on the following information:

Rita Ryan died leaving a will naming her children, John and Dale, as the sole beneficiaries. In her will, Rita designated John as the executor of her estate and excused John from posting a bond as executor. At the time of Rita’s death, she owned a parcel of land with her sister, Ann, as joint tenants with right of survivorship.

17. With respect to Rita’s interest in the land, it will pass to
   a. John and Dale outside Rita’s estate by operation of law.
   b. John and Dale through Rita’s estate after the will is probated.
   c. Ann through Rita’s estate after the will is probated.
   d. Ann outside Rita’s estate by operation of law.

18. In general, John as executor, must
   a. Post a bond despite the provision to the contrary in Rita’s will.
   b. Serve without compensation because John is also a named beneficiary in the will.
   c. File a final account of the administration of the estate.
   d. Relinquish the duties because of the conflict of interest as executor and beneficiary.

Items 23 and 24 are based on the following information:

Frey entered into a contract with Cara Corp. to purchase televisions on behalf of Lux Inc. Lux authorized Frey to enter into the contract in Frey’s name without disclosing that Frey was acting on behalf of Lux.

21. In the absence of a specific provision in a general partnership agreement, partnership losses will be allocated
   a. Equally among the partners irrespective of the allocation of partnership profits.
   b. In the same manner as partnership profits.
   c. In proportion to the partners’ capital contributions.
   d. In proportion to the partners’ capital contributions and outstanding loan balances.

22. The apparent authority of a partner to bind the partnership in dealing with third parties
   a. Would permit a partner to submit a claim against the partnership to arbitration.
   b. Must be derived from the express powers and purposes contained in the partnership agreement.
   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.

19. In general, which of the following statements is correct with respect to a limited partnership?
   a. A limited partner will be personally liable for partnership debts incurred in the ordinary course of the partnership’s business.
   b. A limited partner is unable to participate in the management of the partnership in the same manner as general partners and still retain limited liability.
   c. A limited partner’s death or incompetency will cause the partnership to dissolve.
   d. A limited partner is an agent of the partnership and has the authority to bind the partnership to contracts.

20. Unless otherwise provided for in the partnership agreement, the assignment of a partner’s interest in a general partnership will
   a. Result in the termination of the partnership.
   b. Not affect the assigning partner’s liability to third parties for obligations existing at the time of the assignment.
   c. Transfer the assigning partner’s rights in specific partnership property to the assignee.
   d. Transfer the assigning partner’s right to bind the partnership to contracts to the assignee.

23. If Lux repudiates the contract, Cara may
   a. Obtain specific performance, compelling Lux to perform on the contract.
   b. Hold Frey liable on the contract whether or not Cara discovers that Lux is the principal.
   c. Hold Frey liable on the contract but only if Cara fails to discover that Lux was the principal.
   d. Not hold Lux liable because proof that Lux was the principal will be barred by the parol evidence rule.

24. If Cara repudiates the contract, which of the following statements concerning liability on the contract is not correct?
   a. Frey may hold Cara liable and obtain money damages.
   b. Frey may hold Cara liable and obtain specific performance.
   c. Lux may hold Cara liable upon disclosing the agency relationship with Frey.
   d. Cara will be free from liability to Lux if Frey fraudulently stated that he was acting on his own behalf.
25. Dart Corp. dismissed Ritz as its general sales agent. Dart notified all of Ritz's known customers by letter. Bing Corp., a retail outlet located outside of Ritz's previously assigned sales territory, had never dealt with Ritz. However, Bing knew of Ritz as a result of various business contacts. After his dismissal, Ritz sold Bing goods, to be delivered by Dart, and received from Bing a cash deposit for 20% of the purchase price. It was not unusual for an agent in Ritz's previous position to receive cash deposits. In an action by Bing against Dart on the sales contract, Bing will

a. Win, because Dart's notice was inadequate to terminate Ritz's apparent authority.
b. Win, because a principal is an insurer of an agent's acts.
c. Lose, because Ritz lacked any express or implied authority to make the contract.
d. Lose, because Ritz's conduct constituted a fraud for which Dart is not liable.

Items 26 and 27 are based on the following information:

Brown & Co., CPAs, issued an unqualified opinion on the financial statements of its client, King Corp. Based on the strength of King's financial statements, Safe Bank loaned King $500,000. Brown was unaware that Safe would receive a copy of the financial statements or that they would be used in obtaining a loan by King. King defaulted on the loan.

26. If Safe commences an action for negligence against Brown, and Brown is able to prove that it conducted the audit in conformity with GAAS, Brown will

a. Be liable to Safe because Safe relied on the financial statements.
b. Be liable to Safe because the statute of frauds has been satisfied.
c. Not be liable to Safe because there is a conclusive presumption that following GAAS is equivalent of acting reasonably and with due care.
d. Not be liable to Safe because there was a lack of privity of contract.

27. If Safe commences an action for common law fraud against Brown, then to be successful, Safe must prove in addition to other elements that it

a. Was in privity of contract with Brown.
b. Was not contributorily negligent.
c. Was in privity of contract with King.
d. Justifiably relied on the financial statements.

28. One of the elements necessary to hold a CPA liable to a client for conducting an audit negligently is that the CPA

a. Acted with scienter or guilty knowledge.
b. Was a fiduciary of the client.
c. Failed to exercise due care.
d. Executed an engagement letter.

29. In general, the third party (primary) beneficiary rule as applied to a CPA's legal liability in conducting an audit is relevant to which of the following causes of action against a CPA?

<table>
<thead>
<tr>
<th>Fraud</th>
<th>Constructive fraud</th>
<th>Negligence</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

30. If a CPA recklessly departs from the standards of due care when conducting an audit, the CPA will be liable to third parties who were unknown to the CPA based on

a. Strict liability.
b. Gross negligence.
c. Negligence.
d. Breach of contract.

Items 31 and 32 are based on the following information:

West & Co., CPAs, rendered an unqualified opinion on the financial statements of Pride Corp., which were included in Pride's registration statement filed with the SEC. Subsequently, Hex purchased 500 shares of Pride's preferred stock, which were acquired as part of a public offering subject to the Securities Act of 1933. Hex has commenced an action against West based on the Securities Act of 1933 for losses resulting from misstatements of facts in the financial statements included in the registration statement.

31. Which of the following elements must Hex prove to hold West liable?

a. West rendered its opinion with knowledge of material misstatements.
b. West performed the audit negligently.
c. Hex relied on the financial statements included in the registration statement.
d. The misstatements were material.

32. Which of the following defenses would be least helpful to West in avoiding liability to Hex?

a. West was not in privity of contract with Hex.
b. West conducted the audit in accordance with GAAS.
c. Hex's losses were caused by factors other than the misstatements.
d. Hex knew of the misstatements when Hex acquired the preferred stock.
33. In preparing Watt's 1986 individual income tax return, Stark, CPA, took a deduction contrary to a Tax Court decision that had disallowed a similar deduction. Stark's position was adopted in good faith and with a reasonable belief that the Tax Court decision failed to conform to the Internal Revenue Code. Under the circumstances, Stark will
   a. Not be liable for a preparer penalty unless the understatement of taxes is at least 25% of Watt's tax liability.
   b. Not be liable for a preparer penalty if Stark exercised due diligence.
   c. Be liable for the preparer's negligence penalty.
   d. Be liable for the preparer's penalty because of Stark's intentional disregard of the Tax Court decision.

34. In preparing Tint's 1986 individual income tax return, Boe, CPA, took a $3,000 deduction for unreimbursed travel and entertainment expenses, which Tint stated he paid in 1986. Boe has no reason to believe that documentation of the travel and entertainment expenses is inadequate or non-existent. In order to avoid the preparer's negligence penalty, Boe
   a. May rely solely on Tint's statement as to the amount of the deduction.
   b. Must be advised by Tint that the documentation exists.
   c. Must examine the documentation.
   d. Must maintain copies of the documentation in its file.

35. If a CPA is engaged by an attorney to assist in the defense of a tax fraud case involving the attorney's client, information obtained by the CPA from the client after being engaged
   a. Is not privileged because the matter involves a federal issue.
   b. Is not privileged because the majority of jurisdictions do not recognize an accountant-client privilege.
   c. Will be deemed privileged communications under certain circumstances.
   d. Will be deemed privileged communications provided that the CPA prepared the client's tax return.

36. Bond Corp. issued a negotiable warehouse receipt to Grey for goods stored in Bond's warehouse. Grey's goods were lost due to Bond's failure to exercise such care as a reasonably careful person would under like circumstances. The state in which this transaction occurred follows the UCC rule with respect to a warehouseman's liability for lost goods. The warehouse receipt is silent on this point. Under the circumstances, Bond is
   a. Liable because it was negligent.
   b. Liable because it is strictly liable for any loss.
   c. Not liable unless Grey can establish that Bond was grossly negligent.
   d. Not liable because the warehouse receipt was negotiable.

37. With respect to the sale of goods, the warranty of title
   a. Provides that the seller deliver the goods free from any lien of which the buyer lacked knowledge at the time of contracting.
   b. Provides that the seller can not disclaim the warranty if the sale is made to a bona fide purchaser for value.
   c. Applies only if the seller is a merchant.
   d. Applies only if it is in writing and signed by the seller.

38. In order to establish a cause of action based upon strict liability in tort for personal injuries resulting from the use of a defective product, one of the elements the plaintiff must prove is that the seller (defendant)
   a. Was engaged in the business of selling the product.
   b. Failed to exercise due care.
   c. Defectively designed the product.
   d. Was in privity of contract with the plaintiff.

39. Sand Corp. sold and delivered a photocopier to Barr for use in Barr's business. According to their agreement, Barr may return the copier within 30 days. During the 30-day period, if Barr has not returned the copier or indicated acceptance of it, which of the following statements is correct with respect to risk of loss and title?
   a. Risk of loss and title passed to Barr.
   b. Risk of loss and title remain with Sand.
   c. Risk of loss passed to Barr but title remains with Sand.
   d. Risk of loss remains with Sand but title passed to Barr.

40. An oral agreement concerning the sale of goods entered into without consideration is binding if the agreement
   a. Is a firm offer made by a merchant who promises to hold the offer open for 30 days.
   b. Is a waiver of the non-breaching party's rights arising out of a breach of the contract.
   c. Contradicts the terms of a subsequent written contract that is intended as the complete and exclusive agreement of the parties.
   d. Modifies the price in an existing, enforceable contract from $525 to $475.

41. Wurke, Inc., manufactures and sells household appliances on credit directly to wholesalers, retailers, and consumers. Wurke can perfect its security interest in the appliances without having to file a financing statement or take possession of the appliances if the sale is made by Wurke to
   a. Retailers.
   b. Wholesalers that then sell to distributors for resale.
   c. Consumers.
   d. Wholesalers that then sell to buyers in the ordinary course of business.
42. In order for a security interest in goods to attach, one of the requirements is that the debtor must
   a. Sign a financing statement that adequately describes the goods.
   b. Sign a security agreement that adequately describes the goods.
   c. Receive the goods from the creditor.
   d. Have rights in the goods.

43. On May 8, Westar Corp. sold 20 typewriters to Saper for use in Saper's business. Saper paid for the typewriters by executing a promissory note that was secured by the typewriters. Saper also executed a security agreement. On May 9, Saper filed a petition in bankruptcy and a trustee was appointed. On May 16, Westar filed a financing statement covering the typewriters. Westar claims that it has a superior interest in the typewriters. The trustee in bankruptcy disagrees. Which of the parties is correct?
   a. The trustee, because the filing of a petition in bankruptcy cuts off Westar's rights as of the date of filing.
   b. The trustee, because the petition was filed prior to Westar's filing of the financing statement.
   c. Westar, because it perfected its security interest within ten days after Saper took possession of the typewriters.
   d. Westar, because its security interest was automatically perfected upon attachment.

44. Bean defaulted on a promissory note payable to Gray Co. The note was secured by a piece of equipment owned by Bean. Gray perfected its security interest on May 29, 1987. Bean had also pledged the same equipment as collateral for another loan from Smith Co. after he had given the security interest to Gray. Smith's security interest was perfected on June 30, 1987. Bean is current in his payments to Smith. Subsequently, Gray took possession of the equipment and sold it at a private sale to Walsh, a good faith purchaser for value. Walsh will take the equipment
   a. Free of Smith's security interest because Bean is current in his payments to Smith.
   b. Free of Smith's security interest because Walsh acted in good faith and gave value.
   c. Subject to Smith's security interest because the equipment was sold at a private sale.
   d. Subject to Smith's security interest because Smith is a purchase money secured creditor.

45. Which of the following negotiable instruments is subject to the provisions of the UCC Article on Commercial Paper?
   b. Bill of lading payable to order.
   c. Installment note payable on the first day of each month.
   d. Warehouse receipt.

46. The following instrument has been received by Gary Gold:

   October 30, 1987
   To: Bill Blake
   P.O. Box 37
   Dubuque, Iowa

   Pay to the order of Gary Gold
   Five Thousand and no/100 Dollars

   [Signature]

   Which of the following is correct?
   a. As the drawer, Blake is primarily liable on the instrument.
   b. The instrument is a negotiable note.
   c. The instrument is payable on demand.
   d. As the drawee, Blake is secondarily liable on the instrument.

47. In order to negotiate bearer paper, one must
   a. Endorse the paper.
   b. Endorse and deliver the paper with consideration.
   c. Deliver the paper.
   d. Deliver and endorse the paper.

48. A company has in its possession the following instrument:

   $500.00 Dayton, Ohio October 2, 1987

   Sixty days after date I promise to pay to the order of
   [Signature] Five hundred Dollars
   at Miami, Florida

   Value received with interest at the rate of nine percent per annum.
   This instrument is secured by a conditional sales contract.

   [Signature] No. 11 Due December 1, 1987

   This instrument is
   b. A negotiable bearer note.
   c. A negotiable time draft.
   d. A non-negotiable note since it states that it is secured by a conditional sales contract.
49. One of the requirements necessary to qualify as a holder of a negotiable bearer check is that the transferee must
   a. Take the check in good faith.
   b. Give value for the check.
   c. Have possession of the check.
   d. Receive the check that was originally made payable to bearer.

50. A holder in due course of a negotiable promissory note will take the note subject to which of the following defenses?
   a. Fraud in the inducement.
   b. Failure of consideration.
   c. Unauthorized signature.
   d. Breach of contract.

51. Fine Bank loaned Aker $80,000 to purchase a condominium. Aker executed a promissory note and a mortgage that encumbered the condominium. Fine failed to record the mortgage. With respect to the above transaction, Fine
   a. Will hold legal title to the condominium until the note is paid.
   b. Must file a financing statement to perfect its security interest in the condominium, because the condominium is personal property.
   c. Must sign the note and mortgage in order for them to be effective.
   d. Is entitled to collect the $80,000 from Aker despite its failure to record the mortgage.

52. Lusk borrowed $20,000 from Marco Finance. The loan was secured by a mortgage on a four-unit apartment building owned by Lusk. The proceeds of the loan were used by Lusk to purchase a business. The mortgage was duly recorded 60 days after Marco loaned the money to Lusk. Six months after borrowing the money from Marco, Lusk leased one of the apartments to Rudd for $800 per month. Neither Rudd nor Lusk notified Marco of the lease. Subsequently, Lusk defaulted on the note to Marco and Marco has commenced foreclosure proceedings. Under the circumstances,
   a. Marco’s mortgage is junior to Rudd’s lease because the mortgage was not a purchase money mortgage.
   b. Marco’s mortgage is junior to Rudd’s lease because Marco failed to record the mortgage for 60 days after the closing.
   c. Rudd’s lease is subject to Marco’s mortgage because Marco recorded its mortgage prior to the time Rudd’s leasehold interest arose.
   d. Rudd’s lease is subject to Marco’s mortgage because of the failure to notify Marco of the lease.

53. Which of the following factors is least significant in determining whether an item of personal property has become a fixture?
   a. The extent of injury that would be caused to the real property by the removal of the item.
   b. The value of the item.
   c. The manner of attachment.
   d. The adaptability of the item to the real estate.

Items 54 and 55 are based on the following information:

Hill, Knox, and Lark own a building as joint tenants with the right of survivorship. Hill donated her interest in the building to Care Charity by executing and delivering a deed to Care. Both Knox and Lark refused to consent to Hill’s transfer to Care. Subsequently, Hill and Knox died.

54. As a result of Hill’s transfer to Care, Care acquired
   a. A ½ interest in the building as a joint tenant.
   b. A ½ interest in the building as a tenant in common.
   c. No interest in the building because Knox and Lark refused to consent to the transfer.
   d. No interest in the building because it failed to qualify as a bona fide purchaser for value.

55. As a result of Hill’s and Knox’s death,
   a. Lark owns the entire interest in the building.
   b. Lark owns a ⅓ interest in the building as a tenant in common.
   c. Care and Lark each own a ⅓ interest in the building as joint tenants.
   d. Knox’s heirs and Lark each own a ⅓ interest in the building as tenants in common.

56. Drake Corp. entered into a five-year lease with Samon that provided for Drake’s occupancy of three floors of a high-rise office building at a monthly rent of $16,000. The lease provided that “lessee may sublet the premises but only with the landlord’s (Samon’s) prior written consent”. The lease was silent as to whether Drake could assign the lease. Which of the following statements is correct?
   a. Subletting of the premises with Samon’s consent will relieve Drake from its obligation to pay rent.
   b. Assignment of the lease with Samon’s consent will relieve Drake from its obligation to pay rent.
   c. Samon may refuse to consent to a subsequent sublet even if she has consented to a prior sublet.
   d. Subletting of the premises without Samon’s consent is void.
57. A purchaser of a building who receives real estate title insurance will
   a. Not have coverage for the title exceptions listed in the policy.
   b. Have coverage for title defects that result from events that happen after the effective date of the policy.
   c. Be entitled to transfer the policy to subsequent owners since the policy runs with the property being insured.
   d. Take title to the building free and clear of all record defects since all exceptions to title must be cleared prior to closing.

58. In general, the coinsurance feature of property insurance
   a. Is fixed at a minimum of 80% by law.
   b. Is an additional refinement of the insurable interest requirement.
   c. Precludes the insured from insuring for less than the coinsurance percentage.
   d. Prevents the insured from insuring for a minimal amount and recovering the full amount of losses.

59. With respect to property insurance, the insurable interest requirement
   a. Need only be satisfied at the time the policy is issued.
   b. Must be satisfied both at the time the policy is issued and at the time of the loss.
   c. Will be satisfied only if the insured owns the property in fee simple absolute.
   d. Will be satisfied by an insured who possesses a leasehold interest in the property.

60. On May 5, Sly purchased a warehouse for $100,000. Sly immediately insured the warehouse in the amount of $40,000 with Riff Insurance Co. Six months later, Sly obtained additional fire insurance on the warehouse in the amount of $10,000 from Beek Insurance Co. Both policies contained an 80% coinsurance clause. Sly failed to notify Riff of the policy with Beek. Two years later, while both policies were still in effect, a fire caused by Sly's negligence resulted in $20,000 of damage to the warehouse. At the time of the loss, the warehouse had a fair market value of $50,000. Which of the following will prevent Sly from obtaining the full $20,000 from Riff?
   a. Sly's negligence in causing the fire.
   b. Sly's failure to satisfy the coinsurance clause.
   c. Sly's failure to notify Riff of the policy with Beek.
   d. Sly's purchase of insurance from Beek.

Number 2 (Estimated time — 15 to 20 minutes)

On May 1, Starr Corp., a manufacturer and supplier of computers, mailed a proposed contract to Magic, Inc., offering to sell 20 items of specified computer equipment for $18,000. Magic was engaged in the business of selling computers to the public. Magic accepted Starr's offer by executing and returning the contract to Starr. Starr failed to sign the contract.

On May 15, Starr advised Magic by telephone that, due to certain market conditions, the price of computer parts had increased. Therefore, in order to avoid a loss on the sale to Magic, Starr requested an increase in the sales price to $20,000, which was orally agreed to by Magic. On May 17, Starr sent to Magic a signed letter acknowledging this agreement. Magic did not respond to the letter.

On September 15, Starr notified Magic that the equipment was ready for delivery. Due to substantial changes in computer technology subsequent to May 15, Magic indicated that it no longer wanted the equipment and that it would not pay for it. Starr was unable to resell the computer equipment for any price despite its reasonable efforts to do so. Therefore, Starr commenced a breach of contract action against Magic. Magic asserted the following defenses:

- The May 1 written contract between Starr and Magic is not enforceable because of the statute of frauds.
- Even if the May 1 contract is enforceable, the May 15 oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds.
- In any event, Starr is not entitled to recover the full sales price because the equipment is still in Starr's possession.

Required: Discuss Magic's assertions, indicating whether each is correct or incorrect and setting forth the reasons for any conclusions stated.
Number 3 (Estimated time — 15 to 20 minutes)

On July 1, 1986, Mix was petitioned by Able into bankruptcy under the liquidation provisions of the Bankruptcy Code. Able and Baker are unsecured creditors of Mix, owed $20,000 and $40,000 respectively. Mix also owes Carr $80,000, secured by a valid perfected security interest in bankruptcy on Mix’s machinery, valued at $20,000. Mix has no other debts, except for 1986 federal income taxes.

Shortly after the filing of the petition Lang was appointed trustee in Mix’s bankruptcy. In Lang’s capacity as trustee, Lang:

- Engaged Ring & Co., CPAs, as the accountants for the bankruptcy estate.
- Included as part of the bankruptcy estate, an inheritance that Mix became entitled to receive on December 15, 1986 and that Mix actually received on January 15, 1987.

Lang has sold the property in the estate (including the sale of Mix’s machinery for $20,000, which Carr consented to) and now the sole asset of the estate is $60,000 cash. Lang wishes to distribute the $60,000 so as to satisfy the following claims and expenses of the estate:

- Unsecured claim for 1986 federal income taxes $6,000
- Carr’s claim 80,000
- Able’s and Baker’s claims 60,000
- Expenses necessary to maintain and sell the unsecured property of the estate 1,000
- Ring’s fee for services rendered 3,000

There are no other claims.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Under the facts, were the requirements necessary for the filing of a valid petition in bankruptcy met? Discuss.

b. Discuss whether Lang’s actions in engaging Ring and including the inheritance in the bankruptcy estate were proper.

c. Indicate the order in which the $60,000 should be distributed to satisfy the claims and expenses of the bankruptcy estate, assuming all necessary court approvals have been obtained.

Number 4 (Estimated time — 15 to 20 minutes)

On April 1, Sam Stieb signed and mailed to Bold Corp. an offer to sell Bold a parcel of land for $175,000. On April 5, Bold called Stieb and requested that Stieb keep the offer open until June 1, by which time Bold would be able to determine whether financing for the purchase was available. That same day, Stieb signed and mailed a letter indicating that he would hold the offer open until June 1 if Bold mailed Stieb $100 by April 20.

On April 17, Stieb sent Bold a signed letter revoking his offers dated April 1 and April 5. Bold received that letter on April 19. However, Bold had already signed and mailed on April 18 its acceptance of Stieb’s offer of April 5 along with a check for $100. Stieb received the check and letter of acceptance on April 20.

On May 15, Bold wrote Stieb stating that the $175,000 purchase price was too high but that it would be willing to purchase the land for $160,000. Upon receipt, Stieb immediately sent a telegram to Bold indicating that he had already revoked his offer and that even if his revocation was not effective he considered Bold’s offer a counter-offer which he would not accept. Otherwise, Stieb did nothing as a result of Bold’s May 15 letter.

On May 25, Bold executed and delivered the original contract of April 1 to Stieb without any variation of the original terms.

Stieb does not wish to sell the land to Bold because he has received another offer for $200,000. In order to avoid the sale to Bold for $175,000, Stieb asserts the following:

- Bold could not validly accept Stieb’s offer dated April 5 because $100 was inadequate consideration to hold the offer open until April 20.

- Stieb’s offer dated April 5 had terminated because he had revoked the offer prior to Bold’s acceptance.

- Even if his revocation was not effective, Bold’s letter of May 15 was a counteroffer, which automatically terminated Bold’s right to accept Stieb’s offer of April 1.

Required: Discuss Stieb’s assertions, indicating whether such assertions are correct or incorrect and setting forth the reasons for any conclusions stated.
Mace, Inc., wishes to acquire Creme Corp., a highly profitable company with substantial retained earnings. Creme is incorporated in a state that recognizes the concepts of stated capital (legal capital) and capital surplus.

In conjunction with the proposed acquisition, Mace engaged Gold & Co., CPAs, to audit Creme's financial statements. Gold began analyzing Creme's stated capital account and was provided the following data:

- Creme was initially capitalized in 1980 by issuing 40,000 shares of common stock, 50¢ par value, at $15 per share. The total number of authorized shares was fixed at 100,000 shares.
- Costs to organize Creme were $15,000.
- During 1982, Creme's board of directors declared and distributed a 5% common stock dividend. The fair market value of the stock at that time was $20 per share.
- On June 1, 1983, the president of Creme exercised a stock option to purchase 1,000 shares of common stock at $21 per share when the market price was $25 per share.
- During 1984, Creme's board of directors declared and distributed a 2-for-1 stock split on its common stock when the market price was $28 per share.
- During 1985, Creme acquired as treasury stock 5,000 shares of its common stock at a market price of $30 per share. Creme uses the cost method of accounting and reporting for treasury stock.
- During 1986, Creme reissued 3,000 shares of the treasury stock at the market price of $32 per share.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss what effect each of the transactions described above would have on stated capital (legal capital), indicating the dollar amount of change.

b. Discuss the requirements necessary to properly declare and pay cash dividends.
EXAMINATION IN ACCOUNTING THEORY
(Theory of Accounts)
November 6, 1987; 1:30 to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>Question</th>
<th>Point Value</th>
<th>Estimated Minutes</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 1</td>
<td>60</td>
<td>90-110</td>
</tr>
<tr>
<td>No. 2</td>
<td>10</td>
<td>15-25</td>
</tr>
<tr>
<td>No. 3</td>
<td>10</td>
<td>15-25</td>
</tr>
<tr>
<td>No. 4</td>
<td>10</td>
<td>15-25</td>
</tr>
<tr>
<td>No. 5</td>
<td>10</td>
<td>15-25</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>150-210</strong></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 may 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 d c

Items to be Answered

1. A company records inventory at the gross invoice price. Theoretically, how should the following affect the costs in inventory?

<table>
<thead>
<tr>
<th>Warehousing costs</th>
<th>Cash discounts available</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>d. Increase</td>
<td>No effect</td>
</tr>
</tbody>
</table>

2. During periods of rising prices, when the FIFO inventory cost flow method is used, a perpetual inventory system would
a. Not be permitted.
b. Result in a higher ending inventory than a periodic inventory system.
c. Result in the same ending inventory as a periodic inventory system.
d. Result in a lower ending inventory than a periodic inventory system.

3. 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 reported at its
a. Original cost.
b. Replacement cost.
c. Net realizable value.
d. Net realizable value less the normal profit margin.

4. A company is constructing an asset for its own use. Construction began in 1985. The asset is being financed entirely with a specific new borrowing. Construction expenditures were made in 1985 and 1986 at the end of each quarter. The total amount of interest cost capitalized in 1986 should be determined by applying the interest rate on the specific new borrowing to the
c. Average expenditures for the asset in 1986.
d. Total expenditures for the asset in 1986.

5. A depreciable asset has an estimated 15% salvage value. At the end of its estimated useful life, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

<table>
<thead>
<tr>
<th>Productive output</th>
<th>Sum of the years' digits</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</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>

6. A lessee incurred costs to construct walkways to improve leased property. The estimated useful life of the walkways is fifteen years. The remaining term of the nonrenewable lease is twenty years. The walkway costs should be
a. Capitalized as leasehold improvements and depreciated over twenty years.
b. Capitalized as leasehold improvements and depreciated over fifteen years.
c. Capitalized as leasehold improvements and expensed in the year in which the lease expires.
d. Expensed as incurred.

7. A company using the group depreciation method for its delivery trucks retired one of its delivery trucks after the average service life of the group was reached. Cash proceeds were received from a salvage company. The net carrying amount of these group asset accounts would be decreased by the
a. Original cost of the truck.
b. Original cost of the truck less the cash proceeds.
c. Cash proceeds received.
d. Cash proceeds received and original cost of the truck.

8. According to the FASB conceptual framework, comprehensive income includes which of the following?

<table>
<thead>
<tr>
<th>Gross margin</th>
<th>Operating income</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>
Accounting Theory

9. Legal fees incurred by a company in defending its patent rights should be capitalized when the outcome of the litigation is

<table>
<thead>
<tr>
<th>Successful</th>
<th>Unsuccessful</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>

10. In a sale-leaseback transaction, the seller-lessee retains the right to substantially all of the remaining use of the equipment sold. The profit on the sale should be deferred and subsequently amortized by the lessee when the lease is classified as (an)

<table>
<thead>
<tr>
<th>Capital lease</th>
<th>Operating lease</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>

11. For a capital lease, the amount recorded initially by the lessee as a liability should

a. Exceed the present value at the beginning of the lease term of minimum lease payments during the lease term.

b. Exceed the total of the minimum lease payments during the lease term.

c. Not exceed the fair value of the leased property at the inception of the lease.

d. Equal the total of the minimum lease payments during the lease term.

12. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect on retained earnings?

<table>
<thead>
<tr>
<th>Acquisition of treasury stock</th>
<th>Reissuance of treasury stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>b. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>c. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

13. The partnership agreement for the partnership of Somer and Primrose provided for interest on each partner’s average capital investment. Somer’s average capital investment was more than Primrose’s average capital investment. Profit in excess of interest was allocated equally. If during the year the partnership had profits in excess of the interest on each partner’s average capital investment, the amount of Somer’s partnership capital would

a. Increase the same as Primrose’s.

b. Increase more than Primrose’s.

c. Decrease the same as Primrose’s.

d. Decrease more than Primrose’s.

14. A company changes from an accounting principle that is not generally accepted to one that is generally accepted. The effect of the change should be reported, net of applicable income taxes, in the current

a. Income statement after income from continuing operations and before extraordinary items.

b. Income statement after extraordinary items.

c. Retained earnings statement as an adjustment of the opening balance.

d. Retained earnings statement after net income but before dividends.

15. How would the declaration of a liquidating dividend by a corporation affect each of the following?

<table>
<thead>
<tr>
<th>Contributed capital</th>
<th>Total stockholders' equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

16. When should an anticipated loss on a long-term contract be recognized under the percentage-of-completion method and the completed-contract method, respectively?

<table>
<thead>
<tr>
<th>Percentage-of-Completion</th>
<th>Completed-Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Over life of project</td>
<td>Contract complete</td>
</tr>
<tr>
<td>b. Immediately</td>
<td>Contract complete</td>
</tr>
<tr>
<td>c. Over life of project</td>
<td>Immediately</td>
</tr>
<tr>
<td>d. Immediately</td>
<td>Immediately</td>
</tr>
</tbody>
</table>

17. 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

18. The effect of a material transaction that is infrequent in occurrence but not unusual in nature should be presented separately as a component of income from continuing operations when the transaction results in a

<table>
<thead>
<tr>
<th>Gain</th>
<th>Loss</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>
19. A company issued for no consideration rights to its existing shareholders to purchase, for $30 per share, unissued shares of $15 par value common stock. The common stock account will be
   a. Credited when the rights are exercised.
   b. Credited when the rights are issued.
   c. Debited when the rights are exercised.
   d. Debited when the rights lapse.

20. A research and development activity for which the cost would be expensed as incurred is
   a. Modification of the design of a product.
   b. Trouble-shooting in connection with breakdowns during commercial production.
   c. Routine design of tools.
   d. Engineering follow-through in an early phase of commercial production.

21. An employer offered for a short period of time special termination benefits to some employees. The employees accepted the offer, which provided for immediate lump-sum payments and future payments at the end of the next two years. The amounts can be reasonably estimated. The amount of expense recognized this year should include
   a. One third of the lump-sum payments and one third of the present value of the future payments.
   b. Only the lump-sum payments.
   c. The lump-sum payments and the total of the future payments.
   d. The lump-sum payments and the present value of the future payments.

22. Which of the following should be used for interperiod tax allocation?

<table>
<thead>
<tr>
<th>Comprehensive allocation</th>
<th>Partial allocation</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. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

23. The cumulative effect on prior years' earnings of a change in accounting principle should be reported separately as a component of income after income from continuing operations, for a change from
   b. Percentage-of-completion method of accounting for long-term construction-type contracts to the completed-contract method.
   c. FIFO method of inventory pricing to the weighted-average method.
   d. LIFO method of inventory pricing to the weighted-average method.

24. A segment of a business has been discontinued during the year. The loss on disposal should
   a. Include operating losses of the current period up to the measurement date.
   b. Include employee relocation costs associated with the decision to dispose.
   c. Exclude severance pay associated with the decision to dispose.
   d. Exclude operating losses during the phase-out period.

25. Which of the following should be disclosed in the summary of significant accounting policies?

<table>
<thead>
<tr>
<th>Composition of inventories</th>
<th>Depreciation expense</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>

26. The effect of a change in accounting principle which is inseparable from the effect of a change in accounting estimate should be reported
   a. In the period of change and future periods if the change affects both.
   b. By restating the financial statements of all prior periods presented.
   c. By showing the pro forma effects of retroactive application.
   d. As a correction of an error.

27. Company N donated computer equipment to a university (a nonreciprocal transfer). The fair value of the computer equipment was determinable. The difference between the fair value of the nonmonetary asset transferred and its recorded amount at the date of donation should be recognized in Company N's income statement when the difference results in a

<table>
<thead>
<tr>
<th>Gain</th>
<th>Loss</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>

28. A business combination is accounted for properly as a pooling of interests. Which of the following expenses related to effecting the business combination should enter into the determination of net income of the combined corporation for the period in which the expenses are incurred?

<table>
<thead>
<tr>
<th>Fees of finders and consultants</th>
<th>Registration fees</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>
29. A business combination occurs in the middle of the year. Results of operations for the year of combination would include the combined results of operations of the separate companies for the entire year if the business combination is a

<table>
<thead>
<tr>
<th>Pooling of interests</th>
<th>Purchase</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>

30. Rent 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. 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>

31. When the occurrence of a gain contingency is probable and its amount can be reasonably estimated, the gain contingency should be
a. Recognized in the income statement and disclosed.
b. Classified as an appropriation of retained earnings.
c. Disclosed, but not recognized in the income statement.
d. Neither recognized in the income statement nor disclosed.

32. In financial reporting for segments of a business enterprise, which of the following should be taken into account in computing the amount of an industry segment's identifiable assets?

<table>
<thead>
<tr>
<th>Accumulated depreciation</th>
<th>Allowance for doubtful 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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

33. The if-converted method of computing earnings per share data assumes conversion of convertible securities as of the
a. Beginning of the earliest period reported (or at time of issuance, if later).
b. Beginning of the earliest period reported (regardless of time of issuance).
c. Middle of the earliest period reported (regardless of time of issuance).
d. Ending of the earliest period reported (regardless of time of issuance).

34. A decrease in net accounts receivable should be presented in a statement of changes in financial position prepared on a cash basis (indirect method) as a(an)
   a. Inflow and outflow of cash.
   b. Outflow of cash.
   c. Deduction from income from continuing operations.
   d. Addition to income from continuing operations.

35. A loss on the sale of machinery in the ordinary course of business should be presented in a statement of changes in financial position prepared on a cash basis (indirect method) as a(an)
   a. Deduction from income from continuing operations.
   b. Addition to income from continuing operations.
   c. Inflow and outflow of cash.
   d. Outflow of cash.

36. An employer sponsoring a defined benefit pension plan should
a. Disclose the projected benefit obligation, identifying the accumulated benefit obligation and the vested benefit obligation.
   b. Disclose the projected benefit obligation, identifying the accumulated benefit obligation but not the vested benefit obligation.
   c. Disclose the projected benefit obligation, identifying the vested benefit obligation but not the accumulated benefit obligation.
   d. Not disclose the projected benefit obligation.

37. 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. Adoption date of the plan.
   b. Date of grant.
   c. Measurement date.
   d. Exercise date.

38. 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. Denominator</td>
<td>Denominator</td>
</tr>
<tr>
<td>b. Not used</td>
<td>Numerator</td>
</tr>
<tr>
<td>c. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>d. Numerator</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

39. Personal financial statements should include a

<table>
<thead>
<tr>
<th>Statement of financial condition</th>
<th>Statement of changes in financial position</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>
Examination Questions — November 1987

40. When combined financial statements are prepared for a group of related companies, intercompany transactions and intercompany profits or losses should be eliminated when the group is composed of

<table>
<thead>
<tr>
<th>Commonly controlled companies</th>
<th>Unconsolidated subsidiaries</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. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

41. In a job order cost system using predetermined factory overhead rates, indirect materials usually are recorded initially as an increase in

a. Work in process control.
b. Factory overhead applied.
c. Factory overhead control.
d. Stores control.

42. 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>Budget allowance based on actual hours</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>

43. Actual sales values at the split-off point for joint products Y and Z are not known. For purposes of allocating joint costs to products Y and Z, the relative sales value at split-off method is used. An increase in the costs beyond split-off occurs for product Z, while those of product Y remain constant. If the selling prices of finished products Y and Z remain constant, the percentage of the total joint costs allocated to Product Y and Product Z would

a. Decrease for Product Y and Product Z.
b. Decrease for Product Y and increase for Product Z.
c. Increase for Product Y and Product Z.
d. Increase for Product Y and decrease for Product Z.

44. Residual income is the

a. Contribution margin of an investment center, less the imputed interest on the invested capital used by the center.
b. Contribution margin of an investment center, plus the imputed interest on the invested capital used by the center.
c. Income of an investment center, less the imputed interest on the invested capital used by the center.
d. Income of an investment center, plus the imputed interest on the invested capital used by the center.

45. Direct materials cost is a

<table>
<thead>
<tr>
<th>Period cost</th>
<th>Product cost</th>
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</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</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>

46. In an income statement prepared as an internal report using the variable costing method, which of the following terms should appear?

<table>
<thead>
<tr>
<th>Gross profit (margin)</th>
<th>Operating income</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>

47. 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>No change</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</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>

48. In using cost-volume-profit analysis to calculate expected unit sales, which of the following should be added to fixed costs in the numerator?

a. Predicted operating loss.
b. Predicted operating profit.
c. Unit contribution margin.
d. Variable costs.

49. The capital budgeting technique known as accounting rate of return uses

<table>
<thead>
<tr>
<th>Depreciation expense</th>
<th>Time value of money</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>

50. A company is considering exchanging an old asset for a new asset. Ignoring income tax considerations, which of the following is (are) economically relevant to the decision?

<table>
<thead>
<tr>
<th>Carrying amount of old asset</th>
<th>Disposal value of old asset</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>
Accounting Theory

51. Under which basis of accounting for a governmental unit should revenues be recognized in the accounting period in which they become available and measurable?

<table>
<thead>
<tr>
<th>Accrual basis</th>
<th>Modified accrual basis</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>

52. The estimated revenues control account of a governmental unit is debited when

a. The budget is closed at the end of the year.
b. The budget is recorded.
c. Actual revenues are recorded.
d. Actual revenues are collected.

53. Which of the following accounts of a governmental unit is debited when a purchase order is approved?

a. Appropriations payable.
b. Vouchers payable.
c. Fund balance reserved for encumbrances.
d. Encumbrances control.

54. Which of the following funds of a governmental unit recognizes revenues in the accounting period in which they become available and measurable?

a. Nonexpendable trust.
b. General.
c. Enterprise.
d. Internal service.

55. The debt service fund of a governmental unit is used to account for the accumulation of resources to pay, and the payment of, general long-term debt

<table>
<thead>
<tr>
<th>Principal</th>
<th>Interest</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>

56. Which of the following funds of a governmental unit uses the same basis of accounting as an enterprise fund?

a. Special revenue.
b. Expendable trust.
c. Capital projects.
d. Internal service.

57. Which of the following not-for-profit organizations would use plant funds to account for land, buildings, equipment, and other capital assets?

<table>
<thead>
<tr>
<th>Colleges and universities</th>
<th>Voluntary health and welfare organizations</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>

58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenue, expenditures, and changes in fund balances for

<table>
<thead>
<tr>
<th>Account groups</th>
<th>Proprietary funds</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>

59. A local governmental unit could use which of the following types of funds?

<table>
<thead>
<tr>
<th>Fiduciary</th>
<th>Proprietary</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>

60. The current funds group of a not-for-profit private university includes which of the following?

<table>
<thead>
<tr>
<th>Agency funds</th>
<th>Plant 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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Number 2 (Estimated time — 15 to 25 minutes)

Tidal Company has significant amounts of trade accounts receivable. In March of this year, Tidal assigned specific trade accounts receivable to Herb Finance Company on a with recourse, nonnotification basis as collateral for a loan. Tidal signed a note and received 70 percent of the amount assigned. Tidal was charged a 5 percent finance fee and agreed to pay interest at 12 percent on the unpaid balance. Some specific accounts of the assigned receivables were written off as uncollectible. The remainder of the trade accounts receivable assigned were collected by Tidal in March and April of this year. Tidal paid Herb Finance in full at the end of April of this year.

Tidal also sold some special order merchandise and received a 90-day, 15 percent, interest-bearing note receivable on July 1 of this year. After 30 days, the note receivable was discounted with recourse at 18 percent at a bank.

Required:

a. How should Tidal account for the transactions described above for the assignment of trade accounts receivable?

b. 1. How should Tidal determine the amount of the discount for the note receivable?
   2. How should the discounting transaction be accounted for?
Examination Questions — November 1987

Number 3 (Estimated time — 15 to 25 minutes)

Houston Company has a portfolio of marketable equity securities that it classifies as a current asset. Houston owns less than five percent of the outstanding voting stock of each company's securities in the portfolio. At the beginning of the year, the aggregate market value of the portfolio exceeded its aggregate cost. Cash dividends on these securities were received during the year. All cash dividends received represent distributions of earnings subsequent to Houston's acquisition of these securities. Some 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 aggregate market value.

Houston owns forty percent of the outstanding voting stock of Joy Company. The remainder of Joy's outstanding voting stock is widely dispersed among unrelated investors.

Required:

a. 1. How should Houston report the income statement effects of the cash dividends received during the year on the securities in the portfolio that it classifies as a current asset?
   2. How should Houston report the income statement effects of the securities sold during the year?
   b. How should Houston report the effect of ownership of the portfolio that it classifies as a current asset in its balance sheet as of the end of the year and income statement for the year? Why? Do not discuss the cash dividends or the securities sold.
   c. Identify the method of accounting that Houston should use for its forty percent investment in the outstanding voting stock of Joy. Why is this method appropriate?

Number 4 (Estimated time — 15 to 25 minutes)

Spackenkill Company is a manufacturer of household appliances. During the year, the following information became available:

- Potential costs due to the discovery of a safety hazard related to one of its products — These costs are probable and can be reasonably estimated.
- Potential costs of new product warranty costs — These costs are probable but cannot be reasonably estimated.
- Potential costs due to the discovery of a possible product defect related to one of its products — These costs are reasonably possible and can be reasonably estimated.

Required:

a. How should Spackenkill report the potential costs due to the discovery of a safety hazard? Why?
   b. How should Spackenkill report the potential costs of warranty costs? Why?
   c. How should Spackenkill report the potential costs due to the discovery of a possible product defect? Why?

Number 5 (Estimated time — 15 to 25 minutes)

On January 1, 1985, Brewster Company issued 2,000 of its five-year, $1,000 face value, 11% bonds dated January 1 at an effective annual interest rate (yield) of 9%. Brewster uses the effective interest method of amortization. On December 31, 1986, the 2,000 bonds were extinguished early through acquisition in the open market by Brewster for $1,980,000.

On July 1, 1985, Brewster issued 5,000 of its six-year, $1,000 face value, 10% convertible bonds dated July 1 at an effective annual interest rate (yield) of 12%. The convertible bonds are convertible at the option of the investor into Brewster's common stock at a ratio of 10 shares of common stock for each bond. Brewster uses the effective interest method of amortization. On July 1, 1986, an investor in Brewster's convertible bonds tendered 1,500 bonds for conversion into 15,000 shares of Brewster's common stock which had a market value of $105 per share at the date of the conversion.

Required:

a. 1. Were the 11% bonds issued at par, at a discount, or at a premium? Why?
   2. Would the amount of interest expense for the 11% bonds using the effective interest method of amortization be higher in the first or second year of the life of the bond issue? Why?
   b. 1. How should gain or loss on early extinguishment of debt be determined? Does the early extinguishment of the 11% bonds result in a gain or loss? Why?
      2. How should Brewster report the early extinguishment of the 11% bonds on the 1986 income statement?
   c. 1. Would recording the conversion of the 10% convertible bonds into common stock under the book value method affect net income? What is the rationale for the book value method?
      2. Would recording the conversion of the 10% convertible bonds into common stock under the market value method affect net income? What is the rationale for the market value method?
# ANSWERS TO EXAMINATION

## ACCOUNTING PRACTICE — PART I

November 4, 1987; 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. b</td>
<td>21. b</td>
</tr>
<tr>
<td>2. b</td>
<td>12. b</td>
<td>22. d</td>
</tr>
<tr>
<td>3. c</td>
<td>13. c</td>
<td>23. b</td>
</tr>
<tr>
<td>4. b</td>
<td>14. c</td>
<td>24. c</td>
</tr>
<tr>
<td>5. a</td>
<td>15. c</td>
<td>25. b</td>
</tr>
<tr>
<td>6. c</td>
<td>16. a</td>
<td>26. d</td>
</tr>
<tr>
<td>7. c</td>
<td>17. b</td>
<td>27. d</td>
</tr>
<tr>
<td>8. b</td>
<td>18. d</td>
<td>28. b</td>
</tr>
<tr>
<td>9. a</td>
<td>19. d</td>
<td>29. c</td>
</tr>
<tr>
<td>10. d</td>
<td>20. a</td>
<td>30. c</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>
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### Answer 2

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</table>

### Answer 3

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<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>
Answer 4 (10 points)

**Pell Corporation**

**ANALYSIS OF CHANGES IN PLANT ASSETS**

*For the Year Ended December 31, 1986*

<table>
<thead>
<tr>
<th>Plant Assets</th>
<th>Balance 12/31/85</th>
<th>Increase 12/31/86</th>
<th>Decrease 12/31/86</th>
<th>Balance 12/31/86</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$350,000</td>
<td>$438,000 [1]</td>
<td>$ -</td>
<td>$788,000</td>
</tr>
<tr>
<td>Land improvements</td>
<td>180,000</td>
<td>-</td>
<td>-</td>
<td>180,000</td>
</tr>
<tr>
<td>Building</td>
<td>1,500,000</td>
<td>-</td>
<td>-</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,158,000</td>
<td>287,000 [2]</td>
<td>58,000</td>
<td>1,387,000</td>
</tr>
<tr>
<td>Automobiles</td>
<td>150,000</td>
<td>19,000 [3]</td>
<td>18,000</td>
<td>151,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$3,338,000</strong></td>
<td><strong>$744,000</strong></td>
<td><strong>$76,000</strong></td>
<td><strong>$4,006,000</strong></td>
</tr>
</tbody>
</table>

**Explanations of Amounts:**

[1] **Cost of land acquired 11/1/86**
   Pell stock exchanged (10,000 x $38) $380,000
   Legal fees and title insurance 23,000
   Razing existing building 35,000
   **$438,000**

[2] **Cost of machinery and equipment purchased 1/2/86**
   Invoice cost 260,000
   Installation cost 27,000
   **$287,000**

[3] **Cost recorded for new automobile 12/31/86**
   Carrying amount of trade-in
   [$18,000 - $13,500 (depreciation 150% declining balance at rate of 50% for 2 years)] 4,500
   Cash paid 15,250
   Subtotal 19,750
   Loss on trade-in 750
   **Cost recorded for new automobile $19,000**
Answer 4 (continued)

Pell Corporation

DEPRECIATION EXPENSE
For the Year Ended December 31, 1986

Land improvements
Cost $180,000
Straight-line rate [100% – 15%] × 6 2/3% $12,000
Total depreciation on land improvements

Building
Carrying amount 12/31/85 ($1,500,000 – $350,000) $1,150,000
150% declining balance rate [(100% ÷ 20) × 1½] × 7 ½% 86,250
Total depreciation on building

Machinery and equipment
Balance, 12/31/85 $1,158,000
Deduct machine sold 3/31/86 58,000 $1,100,000
Depreciation straight-line rate × 10% 110,000
Purchased 1/2/86 287,000
Depreciation × 10% 28,700
Machine sold 3/31/86 58,000
Depreciation from 1/1/ to 3/31/86 (10% × ¼) × 2.5% 1,450
Total depreciation on machinery and equipment 140,150

Automobiles
Carrying amount 12/31/85 ($150,000 – $112,000) $38,000
150% declining balance rate [100% ÷ 3 × 1½] × 50% 19,000
Total depreciation on automobiles

Total depreciation expense for 1986 $257,400

c.

Pell Corporation

GAIN OR LOSS FROM PLANT ASSET DISPOSALS
THAT WOULD BE RECOGNIZED IN INCOME STATEMENT
For the Year Ended December 31, 1986

Gain or (loss)

Sale of machine 3/31/86
Selling price $36,500
Carrying amount of machine sold
[$58,000 – $24,650 (Depreciation 4 ¼ years × 10%)] 33,350
Gain on sale 3,150

Trade-in of automobile 12/31/86
Carrying amount of trade-in $4,500 [3]
Trade-in allowed ($19,000 – $15,250) 3,750
Loss on trade-in $750
Gain from asset disposals $2,400

Gain
or (loss)
Examination Answers — November 1987

Answer 5 (10 points)

a. Public Relations Associates
STATEMENT OF CHANGES IN FINANCIAL POSITION
CASH BASIS
For the Year Ended December 31, 1986

Financial resources provided

Cash provided by operations
  Net income $450,000
  Add (or deduct) items not affecting cash
    Depreciation $ 30,000
    Equity in net income of King, Inc. (90,000)
    Amortization of excess cost over
    book value of investment in King 2,000
    Increase in accounts receivable (39,000)
    Increase in accounts payable and
    accrued expenses 25,000
    Cash provided by operations 378,000

Cash from other sources
  Capital investment by Davis 170,000
  Dividends received from King, Inc. 48,000
  Total financial resources provided 596,000

Financial resources used

Partners' drawings 315,000
Purchase of office equipment 85,000
Reduction of mortgage payable 10,000
Total financial resources used 410,000

Increase in cash $186,000

b. Public Relations Associates
ANALYSIS OF CHANGES IN PARTNERS' CAPITAL ACCOUNTS
For the Year Ended December 31, 1986

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Burr</th>
<th>Cox</th>
<th>Davis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 1985</td>
<td>$ 850,000</td>
<td>$510,000</td>
<td>$340,000</td>
<td>$ —</td>
</tr>
<tr>
<td>Capital investment</td>
<td>170,000</td>
<td>—</td>
<td>—</td>
<td>170,000</td>
</tr>
<tr>
<td>Distribution of net income</td>
<td>450,000</td>
<td>225,000</td>
<td>135,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Balance before drawings</td>
<td>1,470,000</td>
<td>735,000</td>
<td>475,000</td>
<td>260,000</td>
</tr>
<tr>
<td>Drawings</td>
<td>315,000</td>
<td>140,000</td>
<td>100,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Balance, December 31, 1986</td>
<td>$1,155,000</td>
<td>$595,000</td>
<td>$375,000</td>
<td>$185,000</td>
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</table>
ANSWERS TO EXAMINATION
ACCOUNTING PRACTICE — PART II
November 5, 1987; 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. b</td>
<td>11. c</td>
<td>21. d</td>
</tr>
<tr>
<td>2. a</td>
<td>12. b</td>
<td>22. c</td>
</tr>
<tr>
<td>3. c</td>
<td>13. c</td>
<td>23. b</td>
</tr>
<tr>
<td>4. d</td>
<td>14. d</td>
<td>24. d</td>
</tr>
<tr>
<td>5. d</td>
<td>15. d</td>
<td>25. a</td>
</tr>
<tr>
<td>6. d</td>
<td>16. c</td>
<td>26. a</td>
</tr>
<tr>
<td>7. a</td>
<td>17. b</td>
<td>27. c</td>
</tr>
<tr>
<td>8. c</td>
<td>18. b</td>
<td>28. c</td>
</tr>
<tr>
<td>9. b</td>
<td>19. a</td>
<td>29. d</td>
</tr>
<tr>
<td>10. a</td>
<td>20. a</td>
<td>30. c</td>
</tr>
</tbody>
</table>

The scores for the multiple choice questions were determined in accordance with the following scales:

**Answer 1**

<table>
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<tr>
<th>Correct</th>
<th>0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0 1½ 2 2½ 3 3½ 4 4½ 5 5½ 6 6½ 7 7½ 8 8½ 9 9½ 10 10 10</td>
</tr>
</tbody>
</table>

**Answer 2**

<table>
<thead>
<tr>
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<th>0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
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</tr>
</tbody>
</table>

**Answer 3**

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0 1½ 2 2½ 3 3½ 4 4½ 5 5½ 6 6½ 7 7½ 8 8½ 9 9½ 10 10 10</td>
</tr>
</tbody>
</table>
Webb & Company
March 1987

Answer 4 (10 points)

(1) **Equivalent Units**

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns completed</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td>Returns in process, 3/31</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Equivalent units</td>
<td>1,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>

(2) **Actual Cost Per Equivalent Unit**

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of returns in process, 3/1</td>
<td>$6,000</td>
<td>$2,500</td>
</tr>
<tr>
<td>Add: March costs</td>
<td>89,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Total</td>
<td>95,000</td>
<td>47,500</td>
</tr>
</tbody>
</table>

Divided by weighted average equivalent units

\[
\frac{950}{1,000} = \frac{47.50}{1,000}
\]

Actual cost per equivalent unit

\[
\frac{95.00}{1,000} = \frac{47.50}{1,000}
\]

b. **Actual Cost of Returns in Process at 3/31**

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor (125 returns \times 80% \times $95.00)</td>
<td>$9,500</td>
<td></td>
</tr>
<tr>
<td>Overhead (125 returns \times 80% \times $47.50)</td>
<td>4,750</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$14,250</td>
<td></td>
</tr>
</tbody>
</table>

c. **Standard Cost Per Return**

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor (5 hrs. \times $20)</td>
<td>$100</td>
<td></td>
</tr>
<tr>
<td>Overhead (5 hrs. \times $10)</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$150</td>
<td></td>
</tr>
</tbody>
</table>

d. **Analysis of March Performance**

(1) Total labor variance (actual minus standard)

\[
$89,000 - (950 \times 50) = $6,000 \text{ favorable}
\]

(2) Labor rate variance

\[
[(89,000/4,000) - 20] \times 4,000 = 9,000 \text{ unfavorable}
\]

(3) Labor efficiency variance

\[
[4,000 - (950 \times 5)] \times 20 = 15,000 \text{ favorable}
\]

(4) Total overhead variance (actual minus standard)

\[
$45,000 - (950 \times 50) = 2,500 \text{ favorable}
\]

(5) Overhead volume variance

\[
$49,000 - (950 \times 50) = 1,500 \text{ unfavorable}
\]

(6) Overhead budget variance

\[
$45,000 - 49,000 = 4,000 \text{ favorable}
\]

*Equivalent units (weighted average method)

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less equivalent units beginning inventory</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>(25% \times 200)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equivalent units for current production</td>
<td>950</td>
<td>950</td>
</tr>
</tbody>
</table>

N-58
Answer 5 (10 points)

Pym Corp. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1986

<table>
<thead>
<tr>
<th>Assets</th>
<th>Pym Corp.</th>
<th>Sy Corp.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>Cash</td>
<td>75,000</td>
<td>15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts and other current receivables</td>
<td>410,000</td>
<td>120,000</td>
<td>[b] 900</td>
<td>[f] 900</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>920,000</td>
<td>670,000</td>
<td>[i] 3,000</td>
<td></td>
</tr>
<tr>
<td>Plant and equipment (net)</td>
<td>1,000,000</td>
<td>400,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Sy Corp.</td>
<td>1,200,000</td>
<td></td>
<td>[a] 90,900</td>
<td>[b] 900</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>[c] 480,000</td>
<td></td>
<td>[d] 48,000</td>
</tr>
<tr>
<td>Totals</td>
<td>3,605,000</td>
<td>1,205,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Liabilities and Stockholders' Equity

<table>
<thead>
<tr>
<th></th>
<th>Pym Corp.</th>
<th>Sy Corp.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>Accounts payable and other current liabilities</td>
<td>140,000</td>
<td>305,000</td>
<td>[f] 900</td>
<td>[g] 5,000</td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>500,000</td>
<td>200,000</td>
<td>[e] 200,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,965,000</td>
<td>700,000</td>
<td>[d] 48,000</td>
<td>[e] 700,000</td>
</tr>
<tr>
<td>Minority interest, 10%</td>
<td></td>
<td></td>
<td>[e] 90,000</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>3,605,000</td>
<td>1,205,000</td>
<td>1,718,700</td>
<td>1,718,700</td>
</tr>
</tbody>
</table>
Answer 5 (continued)

Explanations of Worksheet Adjustments and Eliminations

[a] To record net income of Sy Corp. accruing to Pym Corp.
Sy Corp.'s retained earnings at 12/31/86 $700,000
Sy Corp.'s retained earnings at 1/1/86 600,000
Increase in retained earnings after dividend declaration 100,000
Add dividend declaration 1,000
Sy Corp.'s net income for the year ended 12/31/86 101,000
Pym Corp.'s share, 90% $ 90,900

[b] To record Pym Corp.'s share of dividend declared by Sy Corp.
90% of $1,000 $900

[c] To record goodwill
Purchase price of 90% of Sy Corp.'s common stock $1,200,000
Sy Corp.'s book value at 1/1/86
Common stock $200,000
Retained earnings 600,000
Total $800,000
Pym Corp.'s share, 90% 720,000
Goodwill $ 480,000

[d] To record amortization of goodwill
10% of $480,000 $48,000

[e] To eliminate 90% of Sy Corp.'s book value and record minority interest
Common stock $200,000
Retained earnings at 12/31/86 700,000
Total $900,000
Pym Corp.'s share, 90% $810,000
Minority interest, 10% 90,000
Total $900,000

[f] To eliminate intercompany dividend receivable and payable
90% of $1,000 $900

[g] To eliminate intercompany accrued interest
$100,000 @ 10% × ½ year $5,000

[h] To eliminate intercompany loan $100,000

[i] To eliminate intercompany profit in Sy Corp.'s 12/31 inventory
Sales from Pym Corp. to Sy Corp. $300,000
5% remaining in Sy Corp.'s 12/31 inventory 15,000
Multiply by 20% (60,000/300,000) $ 3,000

[j] To eliminate intercompany trade accounts receivable and payable $90,000
ANSWERS TO EXAMINATION
AUDITING

November 5, 1987; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. a 11. d 21. d 31. a 41. b 51. c
2. b 12. b 22. c 32. a 42. d 52. b
3. a 13. b 23. d 33. c 43. c 53. d
4. d 14. a 24. d 34. b 44. d 54. b
5. d 15. c 25. c 35. b 45. a 55. a
6. c 16. b 26. d 36. d 46. c 56. b
7. b 17. c 27. a 37. d 47. d 57. a
9. c 19. a 29. a 39. b 49. b 59. d
10. a 20. c 30. b 40. c 50. a 60. c

The scores for the multiple choice questions were determined in accordance with the following scales:

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
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<th>2</th>
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</table>
**Answer 2 (10 points)**

**STAR MANUFACTURING, INC.**

**Purchases**

**Internal Accounting Control Questionnaire**

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
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</thead>
<tbody>
<tr>
<td>1. Are there written purchasing policies and procedures?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Are purchase requisitions approved in accordance with management's authorization?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Are purchases made from approved vendors?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Are price quotations requested for purchases over an established amount?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Are purchase commitments documented on written purchase order forms?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Do purchase orders include adequate descriptions, terms, and instructions?</td>
<td></td>
<td></td>
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<td>7. Are purchase orders approved by authorized personnel before issuance?</td>
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<td>8. Are prenumbered purchase order forms periodically accounted for?</td>
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<td>9. Is a detailed listing of purchase orders maintained?</td>
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<td>10. Is the purchasing function independent of receiving, shipping, invoice processing, and treasury functions?</td>
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<td>11. Are there adequate safeguards over unissued purchase order forms?</td>
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<td>12. Are old items in the open purchase order file periodically investigated?</td>
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<td>13. Are vendors notified of conflict of interest policies?</td>
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**Answer 3 (10 points)**

The auditor should

- Review answers to questions on confirmation requests to determine proper recognition in accounting records and the necessity for financial statement disclosure.
- Make inquiries as to compensating balances and restrictions.
- Obtain copies of the bank reconciliations as of the balance sheet date, and
  - Trace the adjusted book balances to the general ledger balances.
  - Compare the bank balances to the opening balances on the cut-off bank statements.
  - Compare the bank balances to the balances on the confirmations.
  - Trace amounts of deposits in transit to the cut-off bank statements and ascertain whether the time lags are reasonable.
  - Verify the clerical accuracy of the reconciliations.
  - Obtain explanation for unusual reconciling items, including checks drawn to "bearer," "cash," and related parties.
  - Trace checks dated prior to the end of the period that were returned with the cut-off statements to the list of outstanding checks.
  - Investigate outstanding checks that did not clear with the cut-off bank statements.
  - Examine a sample of checks for payee, amount, date, authorized signatures, and endorsements to determine any irregularities from company policy or accounting records.
- Prepare a bank transfer schedule from a review of the cash receipts and disbursements journals, bank statements, and related paid checks for the last few days before and the first few days after the year-end, and
  - Review the schedule to determine that the deposit and disbursement of each transfer is recorded in the proper period.
  - Trace incomplete transfers to the schedule of outstanding checks and deposits in transit.
Answer 4 (10 points)

The potential benefits to an auditor of using microcomputer software in an audit as compared to performing an audit without the use of a computer include the following:

1. Time may be saved by eliminating manual footing, cross-footing, and other routine calculations.
2. Calculations, comparisons, and other data manipulations are more accurately performed.
3. Analytical review calculations may be more efficiently performed.
4. The scope of analytical review procedures may be broadened.
5. Audit sampling may be facilitated.
6. Potential weaknesses in a client’s internal accounting control system may be more readily identified.
7. Preparation and revision of flowcharts depicting the flow of financial transactions in a client’s system may be facilitated.
8. Working papers may be easily stored and accessed.
9. Graphics capabilities may allow the auditor to generate, display, and evaluate various financial and nonfinancial relationships graphically.
10. Engagement-management information such as time budgets and the monitoring of actual time vs. budgeted amounts may be more easily generated and analyzed.
11. Customized working papers may be developed with greater ease.
12. Standardized audit correspondence such as engagement letters, client representation letters, and attorney letters may be stored and easily modified.
13. Supervisory-review time may be reduced.
14. Staff morale and productivity may be improved by reducing the time spent on clerical tasks.
15. Client’s personnel may not need to manually prepare as many schedules and otherwise spend as much time assisting the auditor.
16. Computer-generated working papers are generally more legible and consistent.
**Answer 5 (10 points)**

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<tr>
<th>Circumstances</th>
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<th>Report Modification</th>
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<tr>
<td>2. The scope of the auditor's examination is affected by conditions that preclude the application of a necessary auditing procedure.</td>
<td>2. The auditor should express an &quot;except for&quot; qualified opinion or a disclaimer of opinion.</td>
<td>2. The auditor should indicate the scope limitation in the scope paragraph, give the substantive reasons for the limitation in an explanatory paragraph, and modify the opinion paragraph.</td>
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<td>3. The auditor decides to make reference to the report of another auditor as a basis, in part, for expressing an opinion.</td>
<td>3. The auditor should express an unqualified opinion.</td>
<td>3. The auditor should disclose this division of responsibility in the scope paragraph and refer to the other auditor's report in the opinion paragraph.</td>
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<tr>
<td>4. The financial statements are affected by an alternative accounting treatment that is a departure from an accounting principle promulgated by the body designated by AICPA Council to establish such principles. The use of the promulgated principle would cause the financial statements to be misleading.</td>
<td>4. The auditor should express an unqualified opinion.</td>
<td>4. The auditor should give all of the substantive reasons why unusual circumstances justify the use of an alternative accounting treatment in an explanatory paragraph.</td>
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<td>5. The generally accepted accounting principles have not been applied consistently.</td>
<td>5. The auditor should express an &quot;except for&quot; qualified opinion as to consistency.</td>
<td>5. The auditor should explicitly express concurrence by using the expression &quot;with which we concur&quot; in the opinion paragraph.</td>
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<td>6. Uncertainties not susceptible of reasonable estimation affect the financial statements.</td>
<td>6. The auditor should express a &quot;subject to&quot; qualified opinion or a disclaimer of opinion.</td>
<td>6. The auditor should describe the uncertainty in an explanatory paragraph and modify the opinion paragraph.</td>
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<td>7. The auditor wishes to emphasize a matter that is properly accounted for and adequately disclosed in the financial statements.</td>
<td>7. The auditor should express an unqualified opinion.</td>
<td>7. The auditor should describe the matter in an explanatory paragraph.</td>
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ANSWERS TO EXAMINATION

BUSINESS LAW
(Commercial Law)

November 6, 1987; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. d  11. b  21. b  31. d  41. c  51. d
2. d  12. b  22. c  32. a  42. d  52. c
3. c  13. a  23. b  33. b  43. c  53. b
4. a  14. a  24. b  34. b  44. b  54. b
5. a  15. c  25. a  35. c  45. c  55. b
6. a  16. d  26. d  36. a  46. c  56. c
7. c  17. d  27. d  37. a  47. c  57. a
8. c  18. c  28. c  38. a  48. b  58. d
10. c  20. b  30. b  40. d  50. c  60. d

The scores for the multiple choice questions were determined in accordance with the following scales:

| Correct | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 0 | 9 | 10| 11| 12| 13| 14| 15| 16| 17| 18| 19| 20| 21| 22| 23| 24| 25| 26| 27| 28 |

| 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| 46| 47| 48 |
|---------|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 29| 30| 31| 32| 33| 34| 35| 36| 37| 38| 39| 40| 41| 42| 43| 44| 45| 46| 47| 48 |

| Correct | 41| 42| 43| 44| 45| 46| 47| 48| 49| 50| 51| 52| 53| 54| 55| 56| 57| 58| 59| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60 |
|---------|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 49| 50| 51| 52| 53| 54| 55| 56| 57| 58| 59| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60| 60 |

N-65


Answer 2 (10 points)

Magic's first assertion, that the original contract between Starr and itself is not enforceable because of the statute of frauds, is incorrect. The sale of computer equipment is a transaction in goods and thus is governed by the UCC Sales Article. This Article provides that a contract for the sale of goods for the price of $500 or more is not enforceable unless there is some writing sufficient to indicate that a contract for sale has been made between the parties which is signed by the party against whom enforcement is sought. Since the sales price is $18,000, the statute of frauds applies. Magic's execution of the written contract will satisfy the statute of frauds since Magic is the party against whom enforcement of the contract is being sought.

Magic's second assertion, that the oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds, is incorrect. Under the UCC Sales Article, an agreement to modify a contract for the sale of goods need no consideration to be binding. However, the modification must meet the test of good faith, which is defined under the UCC as "honesty in fact in the conduct or transaction concerned and the observance of reasonable commercial standards of fair dealing in the trade." Based upon the facts, it appears that a shift in the market that will result in Starr bearing a loss on the sale to Magic will satisfy the requirement of good faith. In addition, the agreement modifying the sales price must meet the requirements of the statute of frauds if the contract, as modified, is within its provisions. Under the facts, the contract as modified by Magic and Starr, falls within the provisions of the statute of frauds and thus the statute of frauds must be satisfied. Magic's oral agreement to the modification is not sufficient to satisfy the statute of frauds. However, the statute of frauds will be satisfied if: both parties are merchants; a writing in confirmation of the agreement which is sufficient against the sender is received; the recipient receives the writing within a reasonable time; the recipient has reason to know the contents of the writing; and, the recipient fails to give written notice of objection to the contents of the writing within ten days after it is received. As the facts clearly indicate, the mailing of the signed letter by Starr to Magic on May 17 satisfied the aforementioned requirements and thus the modification agreement is enforceable.

Magic's third assertion that Starr is not entitled to recover the full sales price for the equipment is incorrect. The UCC provides that a seller may recover the price of goods identified to a contract and in the possession of the seller if the seller is unable after reasonable effort to resell them at a reasonable price or the circumstances reasonably indicate that such effort will be unavailing. Under the facts of the case at hand, Starr is entitled to recover the full sales price of $20,000 because the equipment could not be resold for any price.

Answer 3 (10 points)

a. Yes. The requirements necessary for the filing of a valid petition in bankruptcy have been met. An involuntary case may be commenced against a person by the filing of a petition where the aggregate amount of unsecured claims is at least $5,000 and a sufficient number of creditors join in the filing of the petition. Where there are fewer than 12 creditors only one creditor need file the petition. Under the facts, the petition was validly filed against Mix because Able's unsecured claim was more than $5,000 and because there were fewer than 12 creditors.

b. Lang's action as trustee to appoint Ring as the accountant for the bankruptcy estate was proper if such action was with the bankruptcy court's approval. The trustee, with the court's approval, may engage professional persons such as accountants on any reasonable terms and conditions.

Lang’s inclusion of the inheritance in the property of the estate was also correct because property of the estate includes property that the debtor acquires or becomes entitled to acquire by inheritance within 180 days after the filing of the petition. By acquiring the right to inherit the property on December 15, 1986, which was less than 180 days after the filing of the petition on July 1, 1986, Mix's inheritance was properly included in the bankruptcy estate. Thus, Mix's receipt of the inheritance more than 180 days after the filing of the petition does not prevent the inclusion of the inheritance in the property of the estate.

c. The $60,000 will be distributed to satisfy the claims and expenses of the bankruptcy estate in the following order of priority:

1. Carr's claim to the extent of the sale proceeds of the machinery in which Carr had a valid perfected security interest in bankruptcy. $20,000
2. Administrative expenses including the expenses to maintain and sell the unsecured property of the estate ($1,000) and Ring's fee for services rendered ($3,000). 4,000
3. Unsecured claim for federal income taxes. 6,000
4. The unsecured claims of Able and Baker and the balance of Carr's claim, which have equal priority, will be paid proportionately as follows:

\[
\begin{align*}
\text{Able} & : \frac{20,000}{120,000} \times 30,000 = 5,000 \\
\text{Baker} & : \frac{40,000}{120,000} \times 30,000 = 10,000 \\
\text{Carr} & : \frac{60,000}{120,000} \times 30,000 = 15,000
\end{align*}
\]

Total distributions $60,000
Answer 4 (10 points)

Stieb's first assertion, that Bold could not validly accept his offer dated April 5 because $100 was inadequate consideration to hold the offer open, is incorrect. In general, the courts will not question the adequacy of consideration if the consideration has legal sufficiency and there is a bargained-for exchange. Adequacy of consideration has nothing to do with legal sufficiency. Thus the subject matter that the parties have exchanged need not have approximately the same value. Based upon the facts, Bold's payment of the $100 in exchange for Stieb's promise to keep the offer open was both legally sufficient and bargained for.

Stieb's second assertion, that his offer dated April 5 had terminated since he had revoked his offer prior to Bold's acceptance, is incorrect. An offer may be terminated by the offeror if a revocation is communicated to the offeree before the offeree accepts. In the majority of states revocation is effective upon receipt of the revocation by the offeree or the offeree's agent. On the other hand, acceptance will generally take effect at the time the acceptance is sent (dispatched) by an authorized means of communication. Bold used an authorized means of communication, i.e., the mail, which was the same method used by Stieb in making the offer. Therefore, Bold's acceptance and payment of $100 on April 18 was effective on that date and formed an option contract. Thus, Stieb's letter of revocation mailed on April 17 was not effective until Bold received the revocation on April 19 by which time an option contract had already been formed and the offer could not be revoked.

Stieb's third assertion, that evenu if his revocation was not effective, Bold's letter of May 15 was a counteroffer, which automatically terminated Bold's right to accept Stieb's offer of April 1, is incorrect. In general, the power of acceptance under an option contract is not terminated by a rejection or counteroffer made by the offeree, unless the requirements are met for the discharge of a contractual duty or the offeror changes its position to its detriment in reliance on such rejection or counteroffer. Although a rejection and/or counteroffer will terminate an offer when communicated, Bold's letter of May 15 will not terminate its right to exercise its option on the land because there was neither a discharge of a contractual duty nor reliance by Stieb to its detriment on the May 15 letter.

Answer 5 (10 points)

a. The initial capitalization of Creme in 1980 would result in $20,000 being allocated to stated capital. Stated capital includes the par value of all shares of the corporation having a par value that have been issued. Therefore, the $20,000 is calculated as follows: 40,000 shares issued \times \text{par value} = 20,000.

The $15,000 of expenses incurred in organizing Creme would not affect stated capital. The Model Business Corporation Act permits payment of organization expenses out of the consideration received by it in payment for its shares if the payment does not render such shares assessable or unpaid. Thus, stated capital remains at $20,000.

The 5% stock dividend would increase stated capital by $1,000 calculated as follows: 40,000 shares \times 5\% \text{ stock dividend} = 2,000 shares \times 50c \text{ par value} = 1,000. The market price of the shares would have no effect on stated capital. Thus, stated capital is $21,000.

The exercise of the stock option by Creme's president would increase stated capital by $500 calculated as follows: 1,000 shares \times 50c \text{ par value} = 500. Neither the price paid by Creme's president nor the market price of the shares on the date the option was exercised would affect stated capital. Thus, stated capital is $21,500.

The 2-for-1 stock split would not affect stated capital. Instead the par value of 50c per share would be reduced to 25c per share and the 43,000 shares of stock issued would be increased to 86,000 shares. Thus, stated capital remains at $21,500.

The acquisition of 5,000 shares as treasury stock at $30 per share by Creme would have no effect on stated capital under the cost method. Thus, stated capital remains at $21,500.

The reissuance of the 3,000 shares of treasury stock at $32 per share would also have no effect on stated capital under the cost method. Thus, stated capital remains at $21,500.

b. Cash dividends may be declared and paid if the corporation is solvent and payment of the dividends would not render the corporation insufficient. 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 prohibits dividend distributions if, after giving effect to the distribution, the corporation's total assets would be less than its total liabilities.
ANSWERS TO EXAMINATION

ACCOUNTING THEORY
(Theory of Accounts)

November 6, 1987; 1:30 P.M. to 5:00 P.M.

Answer 1 (60 points)

1. a 11. c 21. d 31. c 41. d 51. c
2. c 12. b 22. b 32. c 42. d 52. b
3. c 13. b 23. c 33. a 43. d 53. d
4. b 14. c 24. b 34. d 44. c 54. b
5. b 15. b 25. a 35. b 45. c 55. a
6. b 16. d 26. a 36. a 46. d 56. d
7. c 17. b 27. b 37. d 47. a 57. a
9. b 19. a 29. a 39. c 49. d 59. b
10. d 20. a 30. c 40. c 50. b 60. a

The scores for the multiple choice questions were determined in accordance with the following scales:

| Correct | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 0 | 8 | 9 |10 |11 |12 |13 |14 |15 |16 |17  |18  |19  |20  |21  |22  |23  |24  |25  |26  |27  |

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Answer 2 (10 points)

a. Tidal should account for the assignment of trade accounts receivable by debiting trade accounts receivable assigned and crediting trade accounts receivable for the amount of trade accounts receivable assigned. Tidal should account for the note payable to Herb Finance by debiting cash for 70 percent, debiting finance fee expense for 5 percent, and crediting notes payable for 75 percent of the trade accounts receivable assigned.

Tidal should account for the subsequent collections on the trade accounts receivable assigned by debiting cash and crediting trade accounts receivable assigned. Tidal should account for the write off as uncollectible of some specific accounts of the assigned receivables by debiting allowance for doubtful accounts and crediting trade accounts receivable assigned.

Tidal should account for the total payment to Herb Finance by debiting interest expense and notes payable, and crediting cash. The amount of the cash payment consists of both principal (the amount of the note payable) and interest computed at a rate of 12 percent on the balance outstanding.

b. 1. Tidal should determine the amount of the discount for the note receivable as follows:

• Determine the maturity value of the note receivable (the face value of the note receivable plus the 15 percent interest to be earned over the 90-day life of the note receivable).
• Multiply the maturity value of the note receivable by one-sixth (the 60-day life of the discounted note receivable) of the 18 percent discount rate to arrive at the amount of the discount.

2. The discounting transaction should be accounted for by debiting cash and crediting notes receivable discounted. Cash would be debited for the amount received from the bank, and notes receivable discounted, a contra-asset account, generally would be credited for the face value of the note receivable. Also, interest expense should be debited for the difference between the amount received from the bank and the face value of the note receivable at the date of discounting plus interest income earned to the date of discounting and interest revenue should be credited for the interest income earned to the date of discounting. The income and expense, however, are usually netted against each other instead of being recorded separately when the amounts involved are immaterial.

Answer 3 (10 points)

a. 1. Houston should report the cash dividends received during the year as dividend revenue in the income statement.

2. The realized gain or loss on the securities sold during the year should be reported as a part of net income for the current year. The reported realized gains or losses should be measured as the difference(s) between the selling price and the cost of the securities sold.

b. Houston should report the portfolio as a current asset in its balance sheet. The portfolio should be presented at the lower of cost or market. Applying this rule, Houston should report the portfolio at market through the use of a valuation account. The amount by which the aggregate cost of the portfolio exceeded market value at the end of the year should be reported as an unrealized loss in its income statement.

Reporting the portfolio at market value reflects the realizable value of the portfolio at the end of the period. The estimated loss is reported (matched) in the income statement in the period in which the decline in realizable value occurred. Recognition of the lower market value and the anticipated loss is consistent with conservatism.

c. Houston should use the equity method of accounting for its forty percent investment in the outstanding voting stock of Joy. The equity method is appropriate when the company has the ability to exercise significant influence. Houston is presumed to be able to exercise significant influence over Joy because of the size of its investment and the wide dispersion of the remaining shares among unrelated investors.
Answer 4 (10 points)

a. Spackenkill should report the potential costs due to the discovery of a safety hazard as an expense or loss in the income statement and as a liability in the balance sheet because both of the following conditions for accrual are met:

- It is considered probable that a liability has been incurred.
- The amount of loss can be reasonably estimated.

In addition, Spackenkill should disclose the nature of the costs due to the discovery of a safety hazard in the notes to the financial statements.

b. Spackenkill should disclose the nature of the potential costs of warranty costs in the notes to the financial statements. The disclosure should include a statement that an estimate of the possible loss or range of loss cannot be made.

Spackenkill should not report the warranty costs as an expense in the income statement nor as a liability in the balance sheet. Although the warranty costs are probable, they cannot be reasonably estimated.

c. Spackenkill should disclose the nature of the potential costs due to the discovery of a possible product defect in the notes to the financial statements. The disclosure should include an estimate of the possible loss or range of loss.

Spackenkill should not report the costs due to the discovery of a possible product defect as an expense or loss in the income statement nor as a liability in the balance sheet. Although the costs due to the discovery of a possible product defect can be reasonably estimated, they are not probable.

Answer 5 (10 points)

a. 1. The 11% bonds were issued at a premium (more than face value). Although the bonds provide for the payment of interest of 11% of face value, this rate was more than the prevailing or market rate for bonds of similar quality at the time the bonds were issued. Thus, the bonds must sell at a premium to yield 9%.

2. The amount of interest expense would be higher in the first year of the life of the bond issue than in the second year of the life of the bond issue. According to the effective interest method of amortization, the 9% effective interest rate is applied to a declining bond carrying amount, and results in a lower interest expense in each successive year.

b. 1. Gain or loss on early extinguishment of debt should be determined by comparing the net carrying amount of the bonds at the date of extinguishment with the reacquisition price. If the net carrying amount exceeds the reacquisition price, a gain results. If the net carrying amount is less than the reacquisition price, a loss results.

In this case, a gain results. The bonds were issued at a premium, therefore, the carrying amount of the bonds at the date of extinguishment must exceed face value. Thus, the net carrying amount exceeds the reacquisition price.

2. Brewster should report the gain on the early extinguishment in net income for 1986, as an extraordinary item, net of related income tax effect.

c. 1. Net income is not affected by conversion under the book value method. The book value method views the convertible bonds as possessing substantial characteristics of equity capital. The conversion represents the completion of a prior transaction (the issuance of the convertible debt), not the culmination of an earning process.

2. A gain or loss results, and thus net income is affected by conversion under the market value method when market value differs from the carrying amount of the convertible bonds. The market value method views the convertible bonds primarily as debt whose conversion was a significant economic transaction. The conversion represents the culmination of an earning process. 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.
SUGGESTED REFERENCES

November 1987

Accounting Practice — Part I

Numbers 1, 2 and 3
Danos and Imhoff, Intermediate Accounting (Prentice-Hall, 1983).
FASB, Accounting Standards, Current Text (FASB).
Smith and Skousen, Intermediate Accounting, comp. vol., 9th ed. (South-Western, 1987).

Number 4

Number 5
AICPA, Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (AICPA, 1971).
Suggested References

Accounting Practice — Part II

Number 1

A standard tax service, the Internal Revenue Code, Income Tax Regulations, and Estate and Gift Tax Regulations.

Number 2

A standard tax service, the Internal Revenue Code, and Income Tax Regulations.

Number 3

AICPA, Audit and Accounting Guide, Audits of State and Local Governmental Units, Rev. ed. (AICPA, 1986).
Fischer, Taylor, and Leer, Advanced Accounting, 3d ed. (South-Western, 1986).

Number 4


Number 5

Drebin, *Advanced Accounting*, 5th ed. (South-Western, 1982), Chap. 11.
Suggested References

Auditing

Number 1


AICPA, *Codification of Statements on Auditing Standards Nos. 1 to 49* (Commerce Clearing House, 1986).

AICPA, *Codification of Statements on Standards for Accounting and Review Services* Nos. 1 to 5 (Commerce Clearing House, 1983).


Ricchiute, *Auditing Concepts and Standards* (South-Western, 1982).


Number 2


Number 3


Number 4


Number 5

AICPA, *Codification of Statements on Auditing Standards Nos. 1 to 49* (Commerce Clearing House, 1986), sections 509 and 546.


Suggested References

Business Law

Number 1

Anderson, Fox, and Twomney, Business Law, UCC 8th ed. (South-Western, 1983).
Causey, Duties and Liabilities of Public Accountants, rev. ed. (Dow Jones-Irwin, 1982).
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Securities Regulation (Prentice-Hall).
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Securities Act of 1933.
Uniform Commercial Code.

Number 2

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Number 3

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Number 4

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Number 5

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Number 2


Number 3

AICPA, Accounting Principles Board Opinion no. 18, The Equity Method of Accounting for Investments in Common Stock (AICPA, 1971).

Number 4


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INDEX — QUESTIONS

HOW TO USE THIS INDEX: This index presents examination question number references for the four sections of the CPA examination — Accounting Practice Parts I and II, Auditing, Business Law, and Accounting Theory. Each examination section has been organized according to its content specification outline, with questions indexed according to the areas and groups tested.

The question references listed in the right hand column are designated as follows: The question numbers 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(N-4) means multiple choice item number 17 on page N-4; the reference 5(N-14) means essay or problem number 5 on page N-14. Note that, in the Accounting Practice section, no distinction has been made between parts I and II.

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IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles.
   A. Preferred and Common Stock ........................
   B. Additional Paid-in Capital ...........................
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H. Capital Budgeting Techniques ........................................
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- **E. Bonds Payable** ........................................... 5(N-52)
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### IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With GAAP.

- **A. Preferred and Common Stock** ............................
- **B. Additional Paid-in Capital** .................................
- **C. Retained Earnings and Dividends** ....................... 14M(N-47),15M(N-47)
- **D. Treasury Stock and Other Contra Accounts** ........ 12M(N-47)
- **E. Stock Options, Warrants, and Rights** ............... 19M(N-48)
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B. Expenses and Losses 
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B. Accounting Policies
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J. Analysis of Financial Statements
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K. Development Stage Enterprises
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L. Personal Financial Statements
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VII. Cost Accumulation, Planning, and Control.

A. Nature of Cost Elements
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B. Process and Job Order Costing
   44M(N-50)

C. Standard Costing
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D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
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F. Budgeting and Flexible Budgeting
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G. Breakeven and Cost-Volume-Profit Analysis
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H. Capital Budgeting Techniques
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CONTRIBUTORS TO THIS UNIFORM CPA EXAMINATION

The Board of Examiners expresses its gratitude to the following contributors of questions appearing in the November 1987 examination.

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FUTURE CPA EXAMINATION DATES

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CONTENT SPECIFICATION OUTLINES
Content Specification Outlines

The original content specification outlines were adopted by the Board of Examiners in 1981, effective for the November 1983 examination. In 1984 the Board of Examiners modified the original content specification outlines in order to incorporate the information obtained from an AICPA practice analysis study.

The practice analysis study documented the major work segments performed by certified public accountants in the practice of public accountancy and identified the knowledge, skills, and abilities necessary to perform those work segments. These content specification outlines, effective for the May 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,
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

CSO-2
Content Specification Outlines

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

CSO-3
Content Specification Outlines

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

CSO-4
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
Content Specification Outlines

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
Content Specification Outlines

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

CSO-7
Content Specification Outlines

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
Content Specification Outlines

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

CSO-9
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

CSO-10
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
Content Specification Outlines

L. Personal Financial Statements
M. Combined Financial Statements

VII. Cost Accumulation, Planning, and Control (10 percent)

A. Nature of Cost Elements
   1. Direct Materials
   2. Direct Labor
   3. Overhead

B. Process and Job Order Costing
C. Standard Costing
D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
E. Absorption and Variable Costing
F. Budgeting and Flexible Budgeting
G. Breakeven and Cost-Volume-Profit Analysis

H. Capital Budgeting Techniques
   1. Net Present Value
   2. Internal Rates 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

CSO-12
Content Specification Outlines

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

CSO-14
Content Specification Outlines

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 regulations 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

I. The CPA and the Law (10 percent)
   A. Common Law Liability to Clients and Third Persons

CSO-15
B. Federal Statutory Liability

1. Securities Acts
2. Internal Revenue Code

C. Workpapers, Privileged Communication, and Confidentiality

II. Business Organizations (20 percent)

A. Agency

1. Formation and Termination
2. Liabilities of Principal 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
Content Specification Outlines

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 Personalty
2. Types of Ownership
3. Lessor-Lessee
4. Deeds, Recording, Title Defects, and Title Insurance
B. Mortgages
   1. Characteristics
   2. Recording Requirements
   3. Priorities
   4. Foreclosure
C. Administration of Estates and Trusts
D. Fire and Casualty Insurance
   1. Coinsurance
   2. Multiple Insurance Coverage
   3. Insurable Interest