1988

Uniform CPA Examination, May 1984-May 1988, Selected Questions & Unofficial Answers Indexed to Content Specification Outlines

American Institute of Certified Public Accountants, Examinations Division

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_exam

Part of the Accounting Commons
Uniform CPA Examination
May 1984-May 1988

Selected Questions & Unofficial Answers
Indexed To Content Specification Outlines

Accounting Practice
Accounting Theory
Auditing
Business Law

AICPA American Institute of Certified Public Accountants
Selected Questions & Unofficial Answers
Indexed To
Content Specification Outlines

Accounting Practice
Accounting Theory
Auditing
Business Law

Edited by the Staff of the Examinations Division:

James D. Blum
Director
Aubrey Kosson
Senior
Technical Manager
Bruce H. Biskin
Senior
Psychometrician

Technical Managers:
Edward R. Gehl
Lawrence Lindenberg
Alan F. Smith
Ralph Villanova

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 1988 back to May 1984. 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 (84 through 88), 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 1988 Uniform CPA Examination are included at the end of the book. Following the November 1988 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 1989
CONTENTS

May 1984–May 1988 Uniform CPA Examination Selected Questions and Unofficial Answers

Accounting Practice

Accounting Theory

Auditing

Business Law

November 1988 Uniform CPA Examination

Content Specification Outlines
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Selected Questions</th>
<th>Pages</th>
<th>Multiple Choice Items</th>
<th>Problems</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Presentation of Financial Statements or Worksheets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Balance Sheet</td>
<td>AP-1</td>
<td>AP-149</td>
<td></td>
</tr>
<tr>
<td>B. Income Statement</td>
<td>*</td>
<td>AP-149</td>
<td></td>
</tr>
<tr>
<td>C. Statement of Cash Flows</td>
<td>AP-1</td>
<td>AP-158</td>
<td></td>
</tr>
<tr>
<td>D. Statement of Owners' Equity</td>
<td>*</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>E. Consolidated Financial Statements or Worksheets</td>
<td>AP-1</td>
<td>AP-159</td>
<td></td>
</tr>
<tr>
<td>II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles</td>
<td>AP-3</td>
<td>AP-163</td>
<td></td>
</tr>
<tr>
<td>A. Cash, Marketable Securities, and Investments</td>
<td>AP-3</td>
<td>AP-163</td>
<td></td>
</tr>
<tr>
<td>B. Receivables and Accruals</td>
<td>AP-7</td>
<td>AP-164</td>
<td></td>
</tr>
<tr>
<td>C. Inventories</td>
<td>AP-10</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>D. Property, Plant, and Equipment Owned or Leased</td>
<td>AP-13</td>
<td>AP-165</td>
<td></td>
</tr>
<tr>
<td>E. Intangibles and Other Assets</td>
<td>AP-18</td>
<td>AP-166</td>
<td></td>
</tr>
<tr>
<td>III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles</td>
<td>AP-21</td>
<td>AP-167†</td>
<td></td>
</tr>
<tr>
<td>A. Payables and Accruals</td>
<td>AP-21</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Deferred Revenues</td>
<td>AP-26</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Deferred Income Tax Liabilities</td>
<td>AP-29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Capitalized Lease Liability</td>
<td>AP-29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Bonds Payable</td>
<td>AP-31</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Contingent Liabilities and Commitments</td>
<td>AP-35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles</td>
<td>AP-37</td>
<td>AP-168</td>
<td></td>
</tr>
<tr>
<td>A. Preferred and Common Stock</td>
<td>AP-37</td>
<td>AP-168</td>
<td></td>
</tr>
<tr>
<td>B. Additional Paid-in Capital</td>
<td>AP-38</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>C. Retained Earnings and Dividends</td>
<td>AP-39</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>D. Treasury Stock and Other Contra Accounts</td>
<td>AP-41</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>E. Stock Options, Warrants, and Rights</td>
<td>AP-42</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>F. Reorganization and Change in Entity</td>
<td>AP-42</td>
<td>*</td>
<td></td>
</tr>
<tr>
<td>G. Partnerships</td>
<td>AP-43</td>
<td>*</td>
<td></td>
</tr>
</tbody>
</table>

*No multiple choice items/problems were indexed for this group.

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

AP-iii
Selected Questions

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
B. Expenses and Losses
C. Provision for Income Tax
D. Recurring Versus Nonrecurring Transactions and Events
E. Accounting Changes
F. Earnings Per Share

VI. Other Financial Topics

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

A. Nature of Cost Elements
B. Process and Job Order Costing
C. Standard Costing
D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
E. Absorption and Variable Costing
F. Budgeting and Flexible Budgeting
G. Breakeven and Cost-Volume-Profit Analysis
H. Capital Budgeting Techniques
I. Performance Analysis
J. Other

VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting
B. Types of Funds and Fund Accounts
C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
D. Various Types of Not-for-Profit and Governmental Organizations

IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income
B. Exclusions and Adjustments to Arrive at Adjusted Gross Income
C. Gain or Loss on Property Transactions
D. Deductions From Adjusted Gross Income
E. Filing Status and Exemptions
F. Tax Computations and Credits
G. Statute of Limitations
H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

AP-iv
## Selected Questions

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

<table>
<thead>
<tr>
<th>Corporations</th>
<th>Problems</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Determination of Taxable Income or Loss</td>
<td>AP-124</td>
</tr>
<tr>
<td>B. Tax Computations and Credits</td>
<td>AP-130</td>
</tr>
<tr>
<td>C. S Corporations</td>
<td>AP-130</td>
</tr>
<tr>
<td>D. Personal Holding Companies</td>
<td>AP-131</td>
</tr>
<tr>
<td>E. Accumulated Earnings Tax</td>
<td>AP-132</td>
</tr>
<tr>
<td>F. Distributions</td>
<td>AP-133</td>
</tr>
<tr>
<td>G. Tax-Free Incorporation</td>
<td>AP-134</td>
</tr>
<tr>
<td>H. Reorganizations</td>
<td>AP-134</td>
</tr>
<tr>
<td>I. Liquidations and Dissolutions</td>
<td>AP-135</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Partnerships</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>J. Formation of Partnership</td>
<td>AP-135</td>
</tr>
<tr>
<td>K. Basis of Partner's Interest</td>
<td>AP-136</td>
</tr>
<tr>
<td>L. Determination of Partner's Taxable Income and Partner's Elections</td>
<td>AP-136</td>
</tr>
<tr>
<td>M. Accounting Periods of Partnership and Partners</td>
<td>AP-137</td>
</tr>
<tr>
<td>N. Partner Dealing With Own Partnership</td>
<td>AP-137</td>
</tr>
<tr>
<td>O. Treatment of Liabilities</td>
<td>AP-137</td>
</tr>
<tr>
<td>P. Distribution of Partnership Assets</td>
<td>AP-137</td>
</tr>
<tr>
<td>Q. Termination of Partnership</td>
<td>AP-138</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Exempt Organizations</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>R. Types of Organizations</td>
<td>AP-139</td>
</tr>
<tr>
<td>S. Requirements for Exemption</td>
<td>AP-139</td>
</tr>
<tr>
<td>T. Unrelated Business Income</td>
<td>AP-140</td>
</tr>
</tbody>
</table>

Selected Multiple Choice Items — Unofficial Answers  
Problems — Selected Questions  
Selected Problems — Unofficial Answers  
November 1987 Uniform CPA Examination Questions & Unofficial Answers  
Suggested References  
Index  
Content Specification Outlines
MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

1. Presentation of Financial Statements or Worksheets

C. Statement of Cash Flows

In November 1987, the FASB issued "Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows." Accordingly, all previous examination items pertaining to "Statement of Changes in Financial Position," covered by APB Opinion No. 19, Reporting Changes in Financial Position, have been deleted.

E. Consolidated Financial Statements or Worksheets

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

a. $40,000
b. $20,000
c. $16,000
d. $15,000

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

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>($ 8,000)</td>
<td>$2,000</td>
</tr>
<tr>
<td>b.</td>
<td>($ 8,000)</td>
<td>$0</td>
</tr>
<tr>
<td>c.</td>
<td>($10,000)</td>
<td>$2,000</td>
</tr>
<tr>
<td>d.</td>
<td>($10,000)</td>
<td>$0</td>
</tr>
</tbody>
</table>

1M88

Items 13 through 17 are based on the following information:

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

<table>
<thead>
<tr>
<th></th>
<th>Post</th>
<th>Shaw</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$6,500,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>4,400,000</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>6,100,000</td>
<td>5,400,000</td>
</tr>
<tr>
<td></td>
<td>$17,000,000</td>
<td>$9,000,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Post</th>
<th>Shaw</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Six months ended 6/30/87</td>
<td>$1,000,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Six months ended 12/31/87</td>
<td>1,100,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Dividends paid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>April 1, 1987</td>
<td>1,300,000</td>
<td>—</td>
</tr>
<tr>
<td>October 1, 1987</td>
<td>—</td>
<td>350,000</td>
</tr>
</tbody>
</table>

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

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

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

16. In the 1987 consolidated income statement, net income should be reported at
   a. $2,550,000
   b. $2,600,000
   c. $2,820,000
   d. $2,900,000
17. In the December 31, 1987 consolidated balance sheet, total minority interest should be reported at
   a. $950,000
   b. $945,000
   c. $915,000
   d. $900,000

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></th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<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>

<table>
<thead>
<tr>
<th><strong>Liabilities and Stockholders’ Equity</strong></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$100,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>30,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>130,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>220,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>140,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>620,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>980,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Total liabilities and stockholders’ equity</td>
<td>$1,110,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

**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>
</tbody>
</table>

**Par**

| Other operating expenses | 130,000 |
| Operating income         | 100,000 |
| Equity in earnings of Sub | 25,000 |
| Income before income taxes | 125,000 |
| Provision for income taxes | 40,000 |
| Net income               | $85,000 |

**Sub**

| Income before income taxes | 50,000 |
| Provision for income taxes | 20,000 |
| Net income                | $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%.

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

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
Selected Questions

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

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

A. Cash, Marketable Securities, and Investments

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

<table>
<thead>
<tr>
<th>Security</th>
<th>In current assets</th>
<th>In noncurrent assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate cost</td>
<td>$185,000</td>
<td>$275,000</td>
</tr>
<tr>
<td>Aggregate market value</td>
<td>150,000</td>
<td>225,000</td>
</tr>
<tr>
<td>Net unrealized loss</td>
<td>$35,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Income</th>
<th>Stockholders' equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$85,000</td>
</tr>
<tr>
<td>b. $35,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>c. $50,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>d. $85,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

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

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

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

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$36,525</td>
</tr>
<tr>
<td>b.</td>
<td>$36,450</td>
</tr>
<tr>
<td>c.</td>
<td>$36,125</td>
</tr>
<tr>
<td>d.</td>
<td>$36,050</td>
</tr>
</tbody>
</table>

1M87#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:

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$156,500</td>
</tr>
<tr>
<td>b.</td>
<td>$161,500</td>
</tr>
<tr>
<td>c.</td>
<td>$181,500</td>
</tr>
<tr>
<td>d.</td>
<td>$185,000</td>
</tr>
</tbody>
</table>
1N87#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.

1N87#3. On July 1, 1986, Fox Company purchased 400 of the $1,000 face amount, 8% bonds of Dey Corporation 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

1N87#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:

Present value of 1 at 8% for 5 periods 0.68
Present value of 1 at 8% for 6 periods 0.63
Future amount of ordinary annuity of 1 at 8% for 5 periods 5.87
Future amount of annuity in advance of 1 at 8% for 5 periods 6.34

Beal should make five annual deposits (rounded) of

a. $151,200
b. $163,200
c. $189,300
d. $204,400

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#3. On July 1, 1986, Fox Company purchased 400 of the $1,000 face amount, 8% bonds of Dey Corporation 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

1M87#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:

Present value of 1 at 8% for 5 periods 0.68
Present value of 1 at 8% for 6 periods 0.63
Future amount of ordinary annuity of 1 at 8% for 5 periods 5.87
Future amount of annuity in advance of 1 at 8% for 5 periods 6.34

Beal should make five annual deposits (rounded) of

a. $151,200
b. $163,200
c. $189,300
d. $204,400

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>In current assets</th>
<th>In noncurrent assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate cost</td>
<td>$180,000</td>
</tr>
<tr>
<td>Aggregate portfolio market value</td>
<td>$275,000</td>
</tr>
<tr>
<td>Aggregate lower of cost or market value applied to each security in the portfolio</td>
<td>$160,000</td>
</tr>
<tr>
<td>to each security in the portfolio</td>
<td>$225,000</td>
</tr>
<tr>
<td>to each security in the portfolio</td>
<td>$152,000</td>
</tr>
<tr>
<td>to each security in the portfolio</td>
<td>$210,000</td>
</tr>
</tbody>
</table>

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

4. In its December 31, 1986 balance sheet, Taft should report valuation allowances for current and noncurrent 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.

1M87#19. On January 2, 1986, Saxe Company purchased 20% 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
**Selected Questions**

**2N86#15.** The following information pertains to Nu Co. at December 31, 1985:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Check book balance</td>
<td>$6,000</td>
</tr>
<tr>
<td>Bank statement balance</td>
<td>8,000</td>
</tr>
<tr>
<td>Check drawn on Nu Co.'s account, payable to a vendor, dated and recorded, 12/31/85, but not mailed until 1/20/86</td>
<td>900</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per bank statement, 3/31/86</td>
<td>$46,500</td>
</tr>
<tr>
<td>Add: Deposit in transit</td>
<td>10,300</td>
</tr>
<tr>
<td>Less: Outstanding checks</td>
<td>12,600</td>
</tr>
<tr>
<td>Balance per books, 3/31/86</td>
<td>$44,200</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>$58,400</td>
</tr>
<tr>
<td>Disbursements</td>
<td>49,700</td>
</tr>
</tbody>
</table>

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

**2N86#12.** 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><strong>Total</strong></td>
<td><strong>$185,000</strong></td>
<td><strong>$181,500</strong></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>Description</th>
<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</td>
<td>$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</td>
<td>$625,000</td>
</tr>
</tbody>
</table>

In Neal's December 31, 1985, balance sheet, marketable securities should be reported at

a. $1,400,000  
b. $1,450,000  
c. $1,465,000  
d. $1,475,000

**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

**1N85#2.** On December 31, 1984, West Company had the following cash balances:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash in banks</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Petty cash funds (all funds were reimbursed on 12/31/84)</td>
<td>50,000</td>
</tr>
</tbody>
</table>

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#6. On October 1, 1984, Yost Company purchased 400 of the $1,000 face value, 10% bonds of Pell, Inc., for $440,000, which includes accrued interest of $10,000. The bonds, which mature on January 1, 1991, pay interest semiannually on January 1 and July 1. Yost uses the straight-line method of amortization and appropriately recorded the bonds as a long-term investment. The bonds should be shown on Yost's December 31, 1984, balance sheet at:

a. $428,400  
b. $428,800  
c. $430,000  
d. $440,000

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

Balance per bank statement, 3/31/85 $23,250
Add deposit in transit 5,150
Less outstanding checks 6,300
Balance per books, 3/31/85 $22,100

Data per bank for the month of April 1985 follows:

Deposits $29,200  
Disbursements 24,850

All reconciliation items at March 31, 1985, cleared through the bank in April. Outstanding checks at April 30, 1985, totaled $3,500. What is the balance of cash per books at April 30, 1985?

a. $31,100  
b. $26,450  
c. $24,100  
d. $22,950

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

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

In Butler's December 31, 1984, balance sheet, the carrying value of the portfolio should be reported at

a. $106,000  
b. $107,000  
c. $110,000  
d. $111,000

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

a. $1,800  
b. $5,000  
c. $6,500  
d. $8,000

1M84#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.

1M84#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

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

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

AP-6
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?

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

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand and in banks</td>
<td>$975,000</td>
</tr>
<tr>
<td>Cash legally restricted for additions to plant</td>
<td></td>
</tr>
<tr>
<td>(expected to be disbursed in 1985)</td>
<td>600,000</td>
</tr>
<tr>
<td>Bank certificates of deposit</td>
<td></td>
</tr>
<tr>
<td>(due February 1, 1984)</td>
<td>250,000</td>
</tr>
</tbody>
</table>

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”?

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?

B. Receivables and Accruals

1M88#19. Bell, Inc. owns 60% of Dart Corporation’s common stock. On December 31, 1987, Dart is indebted to Bell for a $200,000 cash advance. In preparing the consolidated balance sheet at that date, what amount of the advance should be eliminated?

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

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$1,000,000</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td></td>
<td>$8,000</td>
</tr>
<tr>
<td>Net credit sales</td>
<td></td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

Mann estimates that 3% of the gross accounts receivable will become uncollectible. After adjustment at December 31, 1987, the allowance for doubtful accounts should have a credit balance of

1M87#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

1M87#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>
<thead>
<tr>
<th>Factor</th>
<th>Present value of ordinary annuity of 1 at 12% for 10 periods</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.322</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

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 consolidated balance sheet, Dean should report accounts receivable from investees at

AP-7
1M87#5. 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 receivable 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.
- Forged 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 December 31, 1987 and 1988.

On December 31, 1986, Grey must recognize a loss from restructuring of:
  a. $143,000
  b. $200,000
  c. $204,000
  d. $264,000

1M86#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

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

2N86#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

2N86#16. 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.
Selected Questions

- 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

- $180,000
- $255,000
- $275,000
- $355,000

1M85#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?

- $600,000
- $620,000
- $670,000
- $710,000

1M85#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?

- $48,400
- $49,350
- $49,500
- $52,500

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

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

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

- $886,000
- $850,000
- $836,000
- $786,000

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

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

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

- $60,000
- $58,680
- $48,000
- $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

- $33,000
- $30,000
- $28,000
- $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

- $64,770
- $63,600
- $59,100
- $58,830

1M84#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

- $160,000
- $244,000
- $300,000
- $384,000
Accounting Practice

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

C. Inventories

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

<table>
<thead>
<tr>
<th>Estimated selling price</th>
<th>$204,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated cost of disposal</td>
<td>10,000</td>
</tr>
<tr>
<td>Normal profit margin</td>
<td>30,000</td>
</tr>
<tr>
<td>Current replacement cost</td>
<td>180,000</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>Date</th>
<th>Inventory at current cost</th>
<th>Inventory at base cost</th>
<th>Relevant price index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/86</td>
<td>$150,000</td>
<td>$150,000</td>
<td>1.00</td>
</tr>
<tr>
<td>12/31/86</td>
<td>$220,000</td>
<td>$200,000</td>
<td>1.10</td>
</tr>
<tr>
<td>12/31/87</td>
<td>$276,000</td>
<td>$230,000</td>
<td>1.20</td>
</tr>
</tbody>
</table>

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

1N87#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

1N87#9. Dart Company’s accounting records indicated the following information:

<table>
<thead>
<tr>
<th>Inventory, 1/1/86</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases during 1986</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Sales during 1986</td>
<td>3,200,000</td>
</tr>
</tbody>
</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?

Inventory: 1/1/86 $500,000
Purchases during 1986 2,500,000
Sales during 1986 3,200,000

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.

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

Lot | Number | Sales price
---|--------|--------------
class | of lots | per lot
A | 100 | $12,000
B | 100 | 8,000
C | 200 | 5,000

AP-10
Selected Questions

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>Replacement cost</th>
<th>Net realizable value</th>
<th>Net realizable value less normal profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1.50</td>
<td>.60</td>
<td>1.20</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></th>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/85</td>
<td>$73,500</td>
<td>$101,500</td>
</tr>
<tr>
<td>Purchases</td>
<td>416,500</td>
<td>577,500</td>
</tr>
<tr>
<td>Additional markups</td>
<td></td>
<td>21,000</td>
</tr>
<tr>
<td>Available for sale</td>
<td>$490,000</td>
<td>$700,000</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

1M86#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>Inventory</td>
<td>$2.00</td>
<td>800</td>
<td></td>
</tr>
<tr>
<td>1/8/86</td>
<td>Issue</td>
<td>400</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>1/20/86</td>
<td>Purchase</td>
<td>1,200</td>
<td>$2.40</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

1M86#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></th>
<th>LIFO cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 12/31/84</td>
<td>$360,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Inventory, 12/31/85</td>
<td></td>
<td>660,000</td>
</tr>
<tr>
<td>Increase in price level for 1985</td>
<td></td>
<td>10%</td>
</tr>
<tr>
<td>Cost to retail ratio for 1985</td>
<td></td>
<td>70%</td>
</tr>
</tbody>
</table>

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. $70,000
d. $100,000
1NB5#9. The following information applied to Ott Company for 1984:

<table>
<thead>
<tr>
<th>Merchandise purchased for resale</th>
<th>$600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freight-in</td>
<td>15,000</td>
</tr>
<tr>
<td>Interest on notes payable to vendors</td>
<td>6,000</td>
</tr>
<tr>
<td>Purchase returns</td>
<td>3,000</td>
</tr>
</tbody>
</table>

Ott’s inventoriable cost for 1984 was
a. $600,000
b. $603,000
c. $612,000
d. $618,000

1NB5#10. The following information is available from the records of Bell Company for the year ended December 31, 1984:

<table>
<thead>
<tr>
<th>Inventory, 1/1/84</th>
<th>At cost</th>
<th>At retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>1,320,000</td>
<td>1,840,000</td>
</tr>
<tr>
<td>Additional markups</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Markdowns</td>
<td>160,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>1,920,000</td>
<td></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

1NB5#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

1NB5#10. Marsh Company had 150 units of product A on hand at January 1, 1985, costing $21 each. Purchases of product A during the month of January were as follows:

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

A physical count on January 31, 1985, shows 250 units of product A on hand. The cost of the inventory at January 31, 1985, under the LIFO method is
a. $5,850
b. $5,550
c. $5,350
d. $5,250

1NB5#13. 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><strong>At current year cost</strong></td>
<td><strong>At base year cost</strong></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

1NB4#6. Thomson Company had the following consignment transactions during December 1983:

- Inventory shipped on consignment to Pavin Company, consignee $3,000
- Freight paid by Thomson 100
- Inventory received on consignment from Bellin Company, consignor 5,000
- Freight paid by Bellin 300

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

In its December 31, 1983, balance sheet, Thomson should include consigned inventory of
a. $8,400
b. $8,000
c. $3,100
d. $3,000

1NB4#7. At December 31, 1983, the following information was available from Moore Company’s accounting records:

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/83</td>
<td>$29,400</td>
<td>$40,600</td>
</tr>
<tr>
<td>Purchases</td>
<td>166,600</td>
<td>231,000</td>
</tr>
<tr>
<td>Additional markups</td>
<td></td>
<td>8,400</td>
</tr>
<tr>
<td>Available for sale</td>
<td>$196,000</td>
<td>$280,000</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

1M83#6. Shunpike Company's inventory records for product Y provide the following data for 1983:

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

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

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

1M83#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

D. Property, Plant, and Equipment Owned or Leased

1M85#23. During 1987, Fox Company made the following expenditures relating to plant machinery and equipment:

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

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

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

1M85#24. On January 1, 1985, Parr, Inc. purchased a machine for $600,000 and established an annual depreciation charge of $100,000 over a six-year life. During 1987, after issuing its 1986 financial statements, Parr concluded that the machine's operational value was permanently impaired. It also concluded that $120,000 is a reasonable estimate of the total amount expected to be recovered through remaining use of the machine for the period January 1, 1987 through December 31, 1989. In Parr's December 31, 1987 balance sheet, the machine should be reported at a carrying amount of

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

1M85#25. On March 1, 1987, Kay Company purchased for $450,000 a tract of land as a factory site. An existing building on the property was razed and construction was begun on a new factory building in April 1987. Additional data are available as follows:

<table>
<thead>
<tr>
<th>Cost of razing old building</th>
<th>$ 60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title insurance and legal fees to purchase land</td>
<td>30,000</td>
</tr>
<tr>
<td>Architect's fees</td>
<td>95,000</td>
</tr>
<tr>
<td>New building construction cost</td>
<td>1,850,000</td>
</tr>
</tbody>
</table>

The capitalized cost of the completed factory building should be

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

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 moveable 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:

- Carrying amount of old boiler $4,000
- Fair value of old boiler 1,000
- Purchase and installation price of the new boiler 50,000

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

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 which had been on the land 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

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#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 requirements. 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

1M86#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

1M86#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

1M86#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></th>
<th>Current appraised value</th>
<th>Seller's original cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$200,000</td>
<td>$140,000</td>
</tr>
<tr>
<td>Warehouse building</td>
<td>300,000</td>
<td>280,000</td>
</tr>
<tr>
<td></td>
<td>$500,000</td>
<td>$420,000</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

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:

Building — at book value $260,000  
Building — at fair value 275,000  
Removal and clean-up cost 3,000

During January 1985, before the 1984 financial statements were issued, Glen received insurance proceeds of $250,000. What amount should Glen report on its 1984 income statement as involuntary conversion loss?

a. $10,000  
b. $13,000  
c. $25,000  
d. $28,000

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. $84,000  
c. $70,000  
d. $60,000

5.650 at 12%. Ownership of the property remains with the lessor at expiration of the lease. There is no bargain purchase option. The leased property has an estimated economic life of 12 years. How much should be capitalized by Rice for this leased property?

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

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

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

The capitalized cost of the completed factory building should be

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

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

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

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

a. $45,000  
b. $48,000  
c. $60,000  
d. $80,000

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

a. $0
b. $ 50,000
c. $175,000
d. $325,000

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

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

How much should be charged to repairs and maintenance in 1983?

a. $1,500
b. $4,500
c. $6,000
d. $9,000

1N84#15. On June 1, 1984, Ichor Company entered into a ten-year noncancellable lease with Gillie, Inc., for a machine owned by Gillie. The machine had a fair value of $180,000 at inception of the lease. Ownership of the machine is transferred to Ichor upon expiration of the lease. The present value of the ten $30,000 annual lease payments, based on Ichor's incremental borrowing rate of 12%, is $190,000. The lease agreement specifies that all executory costs are assumed by Ichor. How much should Ichor record as an asset and corresponding liability at the inception of the lease?

a. $0
b. $180,000
c. $190,000
d. $300,000

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

a. $10,533
b. $15,800
c. $15,960
d. $18,960

1N84#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#8. 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moving costs</td>
<td>$20,000</td>
</tr>
<tr>
<td>Reinstallation costs</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

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

E. Intangibles and Other Assets

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent security deposit</td>
<td>$35,000</td>
</tr>
<tr>
<td>First month's rent</td>
<td>15,000</td>
</tr>
<tr>
<td>Last month's rent</td>
<td>15,000</td>
</tr>
<tr>
<td>Nonrefundable reimbursement to lessor for modifications to the leased premises</td>
<td>90,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$155,000</strong></td>
</tr>
</tbody>
</table>

Kemp made timely rental payments August 1 through December 1, 1987. What portion of the payments to the lessor should Kemp have recognized as deferred to years beyond 1987?
- a. $140,000
- b. $131,000
- c. $125,000
- d. $50,000

1M88#27. Frey Corp. incurred $175,000 of research and development costs in its laboratory to develop a patent granted on January 2, 1984. Legal fees and other costs associated with registration of the patent totaled $35,000. On April 25, 1988, Frey paid $50,000 for legal fees in a successful defense of the patent. The total amount capitalized for this patent through April 25, 1988 should be
- a. $260,000
- b. $210,000
- c. $85,000
- d. $35,000
Selected Questions

1N87#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 50 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

1N87#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>Service (normal) cost for 1986</th>
<th>Prior service cost:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amortized</td>
</tr>
<tr>
<td></td>
<td>Funded</td>
</tr>
</tbody>
</table>

West's prepaid pension cost at December 31, 1986, is
   a. $0
   b. $15,500
   c. $41,700
   d. $57,200

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:

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

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>Prepaid royalties</td>
</tr>
<tr>
<td>10/31/85</td>
<td>Royalty payment (charged to royalty expense)</td>
</tr>
<tr>
<td>12/31/85</td>
<td>Year-end credit adjustment to royalty expense</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

1M85#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

1N87#20. During 1986, Kay Company incurred $102,000 of research and development costs in its laboratory to develop a patent which was granted on July 1, 1986. Legal fees and other costs associated with registration of the patent totaled $20,500. The economic life of the patent is estimated at 10 years. What amount should Kay capitalize as a patent on July 1, 1986?
   a. $0
   b. $20,500
   c. $102,000
   d. $122,500
Accounting Practice

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#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></th>
<th>Book value</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$160,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>$180,000</td>
<td>$180,000</td>
</tr>
</tbody>
</table>

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

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

1M84#58. Greene Company bought a franchise from White Company on January 1, 1983, for $102,000. An independent research consultant retained by Greene estimated that the remaining useful life of the franchise was 50 years. Its unamortized cost on White’s books at January 1, 1983, was $34,000. Greene has decided to write off the franchise over the maximum period allowed. How much should be amortized for the year ended December 31, 1983?
   a. $850
   b. $2,000
   c. $2,040
   d. $2,550

1M84#15. Ward Company purchased a patent on January 1, 1980, for $357,000. The patent was being amortized over its remaining legal life of 15 years expiring on January 1, 1995. During 1983 Ward determined that the economic benefits of the patent would not last longer than ten years from the date of acquisition. What amount should be charged to patent amortization expense for the year ended December 31, 1983?
   a. $21,000
   b. $35,700
   c. $40,800
   d. $71,400

1M84#17. In 1983 Stone Corporation received interest income of $50,000 on U.S. Government obligations and $300,000 in royalties under a licensing agreement. Royalties are reported as taxable income in the year received, but in the financial statements, royalties are recognized as income in the year earned and amounted to $200,000 for the year ended December 31, 1983. Stone’s effective income tax rate is 40%. By what amount would the deferred income tax asset account balance increase for 1983?
   a. $20,000
   b. $40,000
   c. $60,000
   d. $80,000

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

A. Payables and Accruals

1M88#28. The balance in Reed Company’s accounts payable account at December 31, 1987 was $1,225,000 before the following information was considered:
   • Goods shipped F.O.B. destination on December 21, 1987 from a vendor to Reed were lost in transit. The invoice cost of $45,000 was not recorded by Reed. On December 28, 1987, Reed notified the vendor of the lost shipment.
   • Goods were in transit from a vendor to Reed on December 31, 1987. The invoice cost was $60,000, and the goods were shipped F.O.B. shipping point on December 28, 1987. Reed received the goods on January 6, 1988.

What amount should Reed report as accounts payable in its December 31, 1987 balance sheet?
   a. $1,330,000
   b. $1,285,000
   c. $1,270,000
   d. $1,225,000

1M88#29. On September 1, 1987, Howe Corp. offered special termination benefits to employees who had reached the early retirement age specified in the company’s pension plan. The termination benefits consisted of lump-sum and periodic future payments. Additionally, the employees accepting the company offer receive the usual early retirement pension benefits. The offer expired on November 30, 1987. Actual or reasonably estimated amounts at December 31, 1987 relating to the employees accepting the offer are as follows:
   • Lump-sum payments totaling $475,000 were made on January 1, 1988.
   • Periodic payments of $60,000 annually for three years will begin January 1, 1989. The present value at December 31, 1987, of these payments was $155,000.
   • Reduction of accrued pension costs at December 31, 1987 for the terminating employees was $45,000.

In its December 31, 1987 balance sheet, Howe should report a total liability for special termination benefits of
   a. $475,000
   b. $585,000
   c. $630,000
   d. $655,000

AP-21
Glen Corp. had the following data relating to its defined benefit pension plan at December 31, 1987:

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

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

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

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

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 the accrued interest payable of:

- a. $44,000
- b. $48,000
- c. $66,000
- d. $72,000

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

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 1, 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

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>Operating Income (Loss)</th>
<th>Income Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>(200,000)</td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>400,000</td>
<td></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
Selected Questions

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>Employee advances</th>
<th>12/31/85</th>
<th>12/31/86</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued salaries payable</td>
<td>$12,000</td>
<td>$18,000</td>
</tr>
</tbody>
</table>

Salaries expense during the year: 815,000
Salaries paid during the year (gross): 780,000

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:

Net pension cost for 1986: $190,000
Unrecognized prior service cost, 12/31/86: 150,000
Accumulated benefit obligation, 12/31/86: 480,000
Fair value of plan assets, 12/31/86: 500,000

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

Current Noncurrent

a. $0 $480,000
b. $0 $330,000
c. $190,000 $150,000
d. $190,000 $0

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:

| Service in advance for January 1986 | $150  
| Local and toll calls for December 1985 | 250 |

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

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

AP-24
**Selected Questions**

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

1N86#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>
<tr>
<td>Totals</td>
<td>$290,000</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>
<tr>
<td>Totals</td>
<td>$313,000</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

2N86#9. Agee Corp. pays its outside salespersons fixed monthly salaries and commissions on net sales. Sales commissions are computed and paid on a monthly basis (in the month following the month of sale), and the fixed salaries are treated as advances against commissions. However, if the fixed salaries for salespersons exceed their sales commissions earned for a month, such excess is not charged back to them. Pertinent data for the month of April 1986 for the three salespersons in sales region 330 are as follows:

<table>
<thead>
<tr>
<th>Salesperson</th>
<th>Fixed salary</th>
<th>Net sales</th>
<th>Commission rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$5,000</td>
<td>$100,000</td>
<td>4%</td>
</tr>
<tr>
<td>B</td>
<td>7,000</td>
<td>200,000</td>
<td>6%</td>
</tr>
<tr>
<td>C</td>
<td>9,000</td>
<td>300,000</td>
<td>6%</td>
</tr>
<tr>
<td>Totals</td>
<td>$21,000</td>
<td>$600,000</td>
<td></td>
</tr>
</tbody>
</table>

For sales region 330, what total amount should Agee accrue for sales commissions payable at April 30, 1986?

a. $13,000  
b. $14,000  
c. $34,000  
d. $35,000

1N85#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>Year</th>
<th>Sinking fund payments</th>
<th>Maturities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$1,000,000</td>
<td>$</td>
</tr>
<tr>
<td>1986</td>
<td>1,000,000</td>
<td>2,500,000</td>
</tr>
<tr>
<td>1987</td>
<td>1,000,000</td>
<td>2,500,000</td>
</tr>
<tr>
<td>1988</td>
<td>1,500,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td>1989</td>
<td>1,500,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td>1990</td>
<td>2,000,000</td>
<td>3,000,000</td>
</tr>
</tbody>
</table>
Accounting Practice

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

- $450,000
- $500,000
- $500,000
- $950,000

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

- $0
- $1,000
- $4,000
- $5,000

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

- $0
- $80,000
- $90,000
- $100,000

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

- $0
- $100,000
- $900,000
- $1,000,000

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

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

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

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

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

- $0
- $16,000
- $42,000
- $58,000

B. Deferred Revenues

1M88#31. Hart Company sells subscriptions to a specialized directory that is published semiannually and shipped to subscribers on April 15 and October 15. Subscriptions received after the March 31 and September 30 cutoff dates are held for the next publication. Cash from subscribers is received evenly during the year, and is credited to deferred revenues from subscriptions. Data relating to 1987 are as follows:

Deferred revenues from subscriptions, balance 12/31/86 $1,500,000
Cash receipts from subscribers 7,200,000

In its December 31, 1987 balance sheet, Hart should report deferred revenues from subscriptions of

- $1,800,000
- $3,300,000
- $3,600,000
- $5,400,000

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

Sales price $220,000
Carrying amount 150,000
Present value of lease rentals ($2,000 for 36 months @ 12%) 60,800
Estimated remaining useful life 10 years
At December 31, 1987, what amount should Ruhl report as deferred revenue from the sale of the equipment?

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

**1N87#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  

**1N87#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, 12/31/86</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  

**1N87#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>Description</th>
<th>Amount</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  

**1N87#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>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$500,000</td>
</tr>
<tr>
<td>1986</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?

a. $360,000  
b. $470,000  
c. $480,000  
d. $630,000  

**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>Duration</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>During 1987</td>
<td>$600,000</td>
</tr>
<tr>
<td>During 1988</td>
<td>900,000</td>
</tr>
<tr>
<td>During 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  

AP-27
1N87#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
Unearned service contract revenue, 1/1/85 570,000

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

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

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

2N86#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

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:

During 1985 — $450,000
During 1986 — 350,000
During 1987 — 275,000

At December 31, 1984, how much should Lock report as unearned service contract revenues?

a. $ 505,000
b. $ 705,000
c. $1,075,000
d. $1,210,000

1N85#22. Moore Company sells magazine subscriptions for one to three-year periods. The magazine sub-
Selected Questions

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:

Uncertain 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. $490,000
c. $490,000
d. $720,000

C. Deferred Income Tax Liabilities

In November 1987, the FASB issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes," superseding APB Opinion No. 11, Accounting for Income Taxes." Accordingly, all previous examination items covered by APB Opinion No. 11 have been deleted.

D. Capitalized Lease Liability

1M88#35. On January 31, 1988, Clay Company leased a new machine from Saxe Corp. The following data relate to the lease transaction at the inception of the lease:

Lease term 10 years
Annual rental payable at beginning of each lease year $50,000
Useful life of machine 15 years
Implicit interest rate 10%
Present value of an annuity of 1 in advance for 10 periods at 10% 6.76
Present value of an annuity of 1 in arrears for 10 periods at 10% 6.15
Fair value of the machine $400,000

The lease has no renewal option, and the possession of the machine reverts to Saxe when the lease terminates. At the inception of the lease, Clay should record a lease liability of

a. $400,000
b. $338,000
c. $307,500
d. $0

1M88#36. On December 30, 1986, Drew Co. leased equipment under a capital lease for a period of 10 years. It contracted to pay $90,000 annual rent on December 31, 1986 and on December 31 of each of the next 9 years. The capital lease liability was appropriately recorded at $688,400 on December 30, 1986, before the first payment. The leased equipment has a useful life of 12 years and the interest rate implicit in the lease is 10%. Drew uses the straightline method in depreciating all equipment. In recording the December 31, 1987 payment, Drew should reduce the capital lease liability by

a. $38,160
b. $50,700
c. $51,840
d. $60,940

1N87#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.

AP-29
At inception of the lease, Frey should record a capitalized lease liability of
a. $1,400,000
b. $1,022,000
c. $798,000
d. $0

1M87#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

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

1M86#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. $505,000
d. $633,000

1M86#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. $800,000

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, and expected to be realized 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
1M85#23. On December 31, 1984, Cobb Company leased a new machine from Gill Company. The following data relate to the lease transaction:

- The machine has an estimated useful life of eight years which coincides with the lease term.
- Lease rentals consist of eight equal annual payments of $100,000, the first of which was paid December 31, 1984.
- Gill's implicit interest rate is 12%, which is known by Cobb.
- Cobb's incremental borrowing rate is 14% at December 31, 1984.
- Present value of an annuity of 1 in advance for eight periods at 12% is 5.56.
- Present value of an annuity of 1 in advance for eight periods at 14% is 5.29.

In its December 31, 1984, balance sheet, Cobb should report a capitalized lease liability of
a. $429,000
b. $456,000
c. $529,000
d. $556,000

E. Bonds Payable

1M88#37. On April 1, 1988, Greg Corp. issued, at 99 plus accrued interest, 200 of its 8%, $1,000 bonds. The bonds are dated January 1, 1988, mature on January 1, 1998, and pay interest on July 1 and January 1. Greg paid bond issue costs of $7,000. From the bond issuance, Greg received net cash of
a. $202,000
b. $198,000
c. $195,000
d. $191,000

1M88#38. On April 30, 1988, Witt Corp. had outstanding 8%, $1,000,000 face amount, convertible bonds maturing on April 30, 1992. Interest is payable on April 30 and October 31. On April 30, 1988, all these bonds were converted into 40,000 shares of $20 par common stock. On the date of conversion:
- Unamortized bond discount was $30,000.
- Each bond had a market price of $1,080.
- Each share of stock had a market price of $28.

Under the book value method, what amount should Witt record as a loss on conversion of bonds?
a. $150,000
b. $110,000
c. $30,000
d. $0

1M88#39. On May 1, 1988, Hill Corp. issued $2,000,000, 20-year, 10% bonds for $2,120,000. Each $1,000 bond had a detachable warrant eligible for the purchase of one share of Hill's $50 par common stock for $60. Immediately after bonds were issued, Hill's securities had the following market values:

<table>
<thead>
<tr>
<th>Bond Description</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% bond without warrant</td>
<td>$1,040</td>
</tr>
<tr>
<td>Warrant</td>
<td>20</td>
</tr>
<tr>
<td>Common stock, $50 par</td>
<td>56</td>
</tr>
</tbody>
</table>

What amount should Hill credit to premium on bonds payable?
- a. $120,000
- b. $80,000
- c. $40,000
- d. $0

1M87#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.

1M87#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>Period</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

1M87#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

1M87#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

1M87#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

1M87#30. Glen Corporation had the following long-term debt:

Sinking fund bonds, maturing in installments $1,100,000
Industrial revenue bonds, maturing in installments 900,000
Subordinated bonds, maturing on a single date 1,500,000

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 $2,254,000 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
Selected Questions

$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

1M86#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

1M86#21. On January 1, 1979, Case, Inc., issued for $970,000, one thousand of its 9%, $1,000 callable 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

1M86#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

1M86#24. On April 1, 1986, Bell, Inc., issued at 97 plus accrued interest, 200 of its 10%, $1,000 bonds. The bonds are dated January 1, 1986, and mature on January 1, 1996. Interest is payable semiannually on January 1 and July 1. From the bond issuance Bell would receive net cash of
   a. $199,000  
   b. $196,500  
   c. $194,000  
   d. $189,000

1M86#31. 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
   a. $176,000  
   b. $224,000  
   c. $260,000  
   d. $280,000

1M86#37. 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?
   a. $ 995,000  
   b. $1,000,000  
   c. $1,020,000  
   d. $1,045,000

2M86#8. 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
   a. $0  
   b. $ 500,000  
   c. $ 900,000  
   d. $1,000,000

2M86#17. 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?
   a. $1,145  
   b. $3,130  
   c. $5,725  
   d. $6,870

AP-33
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?

a. $ 919,000
b. $ 955,000
c. $ 991,000
d. $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:

| Present value of 1 for 10 periods at 10% | .386 |
| Present value of 1 for 20 periods at 5% | .377 |
| Present value of an annuity of 1 for 10 periods at 10% | 6.145 |
| Present value of an annuity of 1 for 20 periods at 5% | 12.462 |

The total issue price of the bonds is
a. $ 875,480
b. $ 877,600
c. $ 980,000
d. $1,000,000

On January 1, 1985, Carr, Inc., issued its 10% bonds in the face amount of $400,000, which mature on January 1, 1995. The bonds were issued for $354,000 to yield 12%, resulting in a bond discount of $46,000. Carr uses the interest method of amortizing bond discount. Interest is payable semiannually on July 1 and January 1. For the six months ended June 30, 1985, Carr should report bond interest expense at
a. $24,000
b. $22,300
c. $21,240
d. $20,000

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

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

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

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:

| Due date | Amounts due Principal Interest Present value  at 12/31/82 |
|----------|------------------|--------|----------------|-----------------|
| 12/31/83 | $40,000          | $16,000| $50,900        |
| 12/31/84 | 40,000           | 12,800 | 43,610         |
| 12/31/85 | 40,000           | 9,600  | 37,250         |
| 12/31/86 | 40,000           | 6,400  | 31,690         |
| 12/31/87 | 40,000           | 3,200  | 26,830         |
|          |                  |        | **$190,280**   |

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

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

F. Contingent Liabilities and Commitments

1NB8#40. Dix Company includes in packages of its products coupons that may be presented at retail stores to obtain discounts on other Dix products. Retailers are reimbursed for the face amount of coupons redeemed plus 10% of that amount for handling costs. Dix honors requests for coupon redemption by retailers up to three months after the consumer expiration date. Dix estimates that 70% of all coupons issued will ultimately be redeemed. Information relating to coupons issued by Dix during 1987 is as follows:

Consumer expiration date 12/31/87
Total face amount of coupons issued $300,000
Total payments to retailers as of 12/31/87 110,000

What amount should Dix report as a liability for unredeemed coupons at December 31, 1987?
   a. $154,000
   b. $121,000
   c. $100,000
   d. $0

1NB8#41. On December 31, 1987, Beal Company was involved in a tax dispute with the IRS. Beal's tax counsel believed that an unfavorable outcome was probable and a reasonable estimate of additional taxes was $350,000, with a chance that the additional taxes could be as much as $850,000. After the 1987 financial statements were issued, Beal accepted an IRS settlement offer of $650,000. What amount of additional taxes should have been charged to income in 1987?
   a. $850,000
   b. $650,000
   c. $550,000
   d. $0

1NB7#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

1NB7#29. 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.

1NB7#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

1NB5#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#29. 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 |

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:

| Actual warranty expenditures |
| Sales | expenditures |
| 1983 | $300,000 | $4,500 |
| 1984 | 500,000 | 15,000 |
| $800,000 | $19,500 |

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
Selected Questions

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

A. Preferred and Common Stock

1N86#42. Park Corp.'s stockholders' equity accounts at December 31, 1987 were as follows:

<table>
<thead>
<tr>
<th>Common stock, $20 par</th>
<th>$8,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>2,550,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,275,000</td>
</tr>
</tbody>
</table>

All shares of common stock outstanding at December 31, 1987 were issued in 1984 for $26 a share. On January 4, 1988, Park reacquired 20,000 shares of its common stock at $24 a share and retired them. Immediately after the shares were retired, the balance in additional paid-in capital would be

- a. $2,430,000
- b. $2,470,000
- c. $2,510,000
- d. $2,590,000

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:

<table>
<thead>
<tr>
<th>Common stock, $10 par; authorized 1,000,000 shares; issued and outstanding 900,000 shares</th>
<th>$ 9,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>2,700,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>$13,000,000</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>8% cumulative preferred stock, $50 par; liquidating value $55 per share; authorized, issued and outstanding 20,000 shares</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $25 par; 200,000 shares authorized; 100,000 shares issued and outstanding</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>400,000</td>
</tr>
</tbody>
</table>

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

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

All of the outstanding common stock and treasury stock were originally issued in 1981 for $11.00 per share. The treasury stock is common stock reacquired on March 31, 1983. Beef uses the par value method of accounting for treasury stock.

During 1984 the following events or transactions occurred relating to Beef's stockholders' equity:

- **February 12, 1984** — Issued 400,000 shares of unissued common stock for $12.50 per share.
- **June 15, 1984** — Declared a cash dividend of $0.20 per share to stockholders of record on April 1, 1984, and payable on April 15, 1984. This was the first dividend ever declared by Beef.

AP-37
• 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

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

1M85#16. Landy Corporation was organized on January 2, 1984, with authorized capital of 100,000 shares

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

AP-38
Selected Questions

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

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

<table>
<thead>
<tr>
<th>Common stock, $1 par value;</th>
<th>$1,400,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>authorized 3,000,000 shares;</td>
<td></td>
</tr>
<tr>
<td>issued 1,500,000 shares;</td>
<td></td>
</tr>
<tr>
<td>outstanding 1,400,000 shares</td>
<td>$ 1,400,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Additional paid-in capital:</th>
</tr>
</thead>
<tbody>
<tr>
<td>In excess of par</td>
</tr>
<tr>
<td>From treasury stock</td>
</tr>
</tbody>
</table>

| 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.

- 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 accrutable 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:

Common stock, par value $10; authorized 30,000 shares; issued and outstanding 9,000 shares $ 90,000
Additional paid-in capital 116,000
Retained earnings 146,000
Total stockholders’ equity $352,000

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
Selected Questions

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

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

The $800,000 dividend includes a liquidating dividend of:

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

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

a. $150,000 credit.
b. $350,000 debit.
c. $500,000 debit.
d. $650,000 credit.

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:

<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>
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.

E. Stock Options, Warrants, and Rights

1M87#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. $5,500

1M86#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></th>
<th>January 1, 1984</th>
<th>December 31, 1985</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$60</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

1M84#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

1M86#44. Kent, Inc. has been forced into bankruptcy and has begun to liquidate. Unsecured claims will be paid at the rate of 40 cents on the dollar. Apex Co. holds a noninterest bearing note receivable from Kent in the amount of $100,000, collateralized by machinery with a liquidation value of $25,000. The total amount to be realized by Apex on this note receivable is
   a. $25,000
   b. $40,000
   c. $55,000
   d. $65,000

1M86#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

Items 18 and 19 are based on the following data:

On January 1, 1984, Neel Corp. issued 400,000 additional shares of $10 par value common stock in exchange for all of Pym Corp.'s common stock. Immediately before this business combination, Neel's stockholders' equity was $16,000,000 and Pym's stockholders' equity was $8,000,000. On January 1, 1984, fair market value of Neel's common stock was $20 per share, and fair market value of Pym's net assets was $8,000,000. Neel's net income for the year ended December 31, 1984, exclusive of any consideration of Pym, was $2,500,000. Pym's net income for the year ended December 31, 1984, was $600,000. During 1984 Neel paid dividends of $900,000. Neel had no business transactions with Pym in 1984.

AP-42
Selected Questions

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

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

| Current assets         | $140,000 |
| Equipment (net)        | 130,000  |
| Liabilities            | $ 70,000 |
| John Dunn, Capital     | 200,000  |

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

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

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 nonpriority claims?
   a. $240,000
   b. $180,000
   c. $160,000
   d. $125,000

G. Partnerships

1M87#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><strong>Total</strong></td>
<td><strong>$300,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
<th></th>
</tr>
</thead>
<tbody>
<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><strong>Total</strong></td>
<td><strong>$300,000</strong></td>
</tr>
</tbody>
</table>
Accounting Practice

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

1M87#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.

1M86#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:

- **Cash** $90,000
- **Other assets** $830,000
- **Lever, loan** $20,000

**Total Capital** $940,000

- **Accounts payable** $210,000
- **Quint, loan** $30,000
- **Lever, capital** $310,000
- **Polen, capital** $200,000
- **Quint, capital** $190,000

**Total Capital** $940,000

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

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

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

a. $300,000  
b. $330,000  
c. $340,000  
d. $360,000  

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.
Selected Questions

The average capital investments for 1983 were:

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

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

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

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

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ames</td>
<td>$70,000</td>
<td></td>
</tr>
<tr>
<td>Buell</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Carter</td>
<td>$130,000</td>
<td></td>
</tr>
</tbody>
</table>

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

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ames</td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td>Buell</td>
<td>$56,667</td>
<td></td>
</tr>
<tr>
<td>Carter</td>
<td>$60,000</td>
<td></td>
</tr>
</tbody>
</table>

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

1M88#45. Tara Company reported revenue of $1,980,000 in its income statement for the year ended December 31, 1987. Additional information was as follows:

<table>
<thead>
<tr>
<th></th>
<th>12/31/86</th>
<th>12/31/87</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for doubtful</td>
<td>$415,000</td>
<td>$550,000</td>
</tr>
<tr>
<td>accounts</td>
<td>25,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

No uncollectible accounts were written off during 1987. Had the cash basis of accounting been used instead, Tara would have reported receipts for 1987 of

- a. $2,115,000
- b. $1,885,000
- c. $1,860,000
- d. $1,845,000

1M88#47. On September 1, 1987, Bain Corp. received an order for equipment from a foreign customer for 300,000 local currency units (LCU) when the U.S. dollar equivalent was $96,000. Bain shipped the equipment on October 15, 1987, and billed the customer for 300,000 LCU when the U.S. dollar equivalent was $100,000. Bain received the customer's remittance in full on November 16, 1987, and sold the 300,000 LCU for $105,000. In its income statement for the year ended December 31, 1987, Bain should report a foreign exchange gain of

- a. $0
- b. $4,000
- c. $5,000
- d. $9,000

1N87#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></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>
</tbody>
</table>

Contract costs incurred during 1986 were

- a. $3,200,000
- b. $3,300,000
- c. $3,500,000
- d. $4,800,000

1N87#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.

AP-45
In its 1986 income statement, how much should Ball report as total infrequent gains which are not considered extraordinary?

a. $520,000  
b. $530,000  
c. $330,000  
d. $280,000

1N87/32. 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

1N87/33. 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

1N87/34. 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>$75,000</td>
<td>$80,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Unearned royalties</th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>45,000</td>
<td>65,000</td>
<td></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

1N87/37. 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

1N87/38. 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 from:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985 sales</td>
<td>400,000</td>
<td>500,000</td>
</tr>
<tr>
<td>1986 sales</td>
<td></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

1N87/39. 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

1N87/35. 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>Accounts receivable,</th>
<th>Current rates</th>
<th>Historical rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>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></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

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

2M87#3. On January 1, 1986, Neu Co. sold equipment costing $380,000, 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

2M87#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

2M87#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

2M87 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

AP-47
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>
<tr>
<td></td>
<td>7,000</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

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#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>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
</tr>
<tr>
<td>7,800,000</td>
</tr>
<tr>
<td>Cumulative contract costs incurred</td>
</tr>
<tr>
<td>Estimated total costs at completion</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 $275,000 for the last half of 1985. How much royalty income should Kemp report in its 1985 income statement?

a. $25,000
b. $45,000
c. $47,500
d. $52,500

1N86#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

a. $35,000
b. $40,000
c. $43,750
d. $50,000

1N86#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 $7,750. Taft's net rental income for 1985 should be

a. $20,700
b. $22,000
c. $22,500
d. $30,000

1N86#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?

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

a. $3,285,000
b. $3,200,000
c. $3,115,000
d. $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:

Income recognized at 12/31/84 $ 600,000
Cost incurred 1/10/84 through 12/31/85 3,600,000
Estimated cost to complete at 12/31/85 1,200,000

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

a. $300,000
b. $525,000
c. $600,000
d. $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></th>
<th>November 1985</th>
<th>December 1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$0</td>
<td>$8,000</td>
</tr>
<tr>
<td>b.</td>
<td>$0</td>
<td>$7,800</td>
</tr>
<tr>
<td>c.</td>
<td>$23,400</td>
<td>$0</td>
</tr>
<tr>
<td>d.</td>
<td>$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?

a. $0
b. $100,000
c. $180,000
d. $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 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>$55,000</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>

1N85#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.
- Goods with an invoice amount of $80,000 were billed to a customer on January 3, 1985. The goods were shipped on December 31, 1984.
- On January 5, 1985, a customer notified Ward that goods billed and shipped on December 23, 1984, were lost in transit. The invoice amount was $100,000.

Ward’s adjusted net sales for 1984 should be

a. $2,330,000
b. $2,280,000
c. $2,250,000
d. $2,230,000

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 40%
- Deferred gross profit at 12/31/84 $240,000
- Cash collected, including down payments 450,000

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:

- Progress billings $3,300,000
- Costs incurred 2,700,000
- Collections 2,100,000
- Estimated cost to complete 5,400,000

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.
Accounting Practice

- 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 Company personnel was sold to Fox Publishing, Inc., for royalties of 10% on sales. Royalties are receivable semiannually on March 31, for sales in July through December of the prior year, and on September 30, for sales in January through June of the same year.

- Royalty income of $18,000 was accrued at 12/31/83 for the period July — December 1983.
- Royalty income of $20,000 was received on 3/31/84, and $26,000 on 9/30/84.
- Burr learned from Fox that sales subject to royalty were estimated at $270,000 for the last half of 1984.

In its income statement for 1984, Burr should report royalty income at

a. $46,000
b. $48,000
c. $53,000
d. $55,000

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

1N85#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>

1N85#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

1N85#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. $(6,500)
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 |
Selected Questions

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. $30,000

1M85#32. On January 2, 1984, Kiner Company sold the copyright to a book to Western Publishers, Inc., for royalties of 20% of future sales. The same date Western paid Kiner a royalty advance of $50,000 to be applied against royalties for 1985 sales. On September 30, 1984, Western made a $21,000 royalty remittance to Kiner for sales in the six-month period ended June 30, 1984. In January 1985, before issuance of its 1984 financial statements, Kiner learned that Western's sales of the book totaled $125,000 for the last half of 1984. How much royalty income should Kiner report in its 1984 income statement?
  a. $21,000
  b. $46,000
  c. $71,000
  d. $75,000

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 Gor-
don 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.

1N85#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:

| At 12/31/81 | $500,000 | $5,000,000 |
| At 12/31/82 | 2,750,000 | 5,500,000 |
| At 12/31/83 | 5,000,000 | 6,000,000 |

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</th>
<th>6 months ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/83</td>
<td>12/31/83</td>
</tr>
<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
Selected Questions

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

1M84#43. Dalton Company owns 1,000 shares of Reber, Inc., $10 par value common stock which was acquired on July 1, 1983, at a cost of $19,000. On April 30, 1984, Reber issued a 10% common stock dividend when the market price of its common stock was $24 per share. As a result of this stock dividend, Dalton should record dividend income of

a. $2,400
b. $1,900
c. $1,000
d. $0

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

a. $38,000
b. $53,000
c. $125,000
d. $178,000

1M84#48. Walker, Inc., a U.S. corporation, ordered a machine from 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>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Progress billings</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Costs incurred</td>
<td>900,000</td>
</tr>
<tr>
<td>Collections</td>
<td>700,000</td>
</tr>
<tr>
<td>Estimated cost to complete</td>
<td>1,800,000</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 $300,000, 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>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$30,000</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>None</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>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalties receivable</td>
<td>$90,000</td>
</tr>
<tr>
<td>Unearned royalties</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

AP-55
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

B. Expenses and Losses

1M88#48. The following information is available from Dell Company’s 1987 accounting records:

<table>
<thead>
<tr>
<th>Purchases</th>
<th>$530,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase discounts</td>
<td>10,000</td>
</tr>
<tr>
<td>Beginning inventory</td>
<td>160,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>215,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Dell’s 1987 cost of goods sold is

a. $465,000  
b. $475,000  
c. $505,000  
d. $585,000

1M88#49. At December 31, 1987, Cobb Company had a $695,000 balance in its advertising expense account before any year-end adjustments relating to the following:

- Included in the $695,000 is $80,000 for printing sales catalogs for a January 1988 sales promotional campaign.
- Television advertising spots telecast during December 1987 were billed to Cobb on January 2, 1988. The invoice cost of $45,000 was paid on January 11, 1988.

Cobb’s advertising expense for the year ended December 31, 1987 should be

a. $740,000  
b. $660,000  
c. $615,000  
d. $570,000

1M88#51. Wren Company had the following account balances at December 31, 1987:

<table>
<thead>
<tr>
<th>Accounts receivable</th>
<th>$900,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for doubtful accounts (before any provision for 1987 doubtful accounts expense)</td>
<td>16,000</td>
</tr>
<tr>
<td>Credit sales for 1987</td>
<td>1,750,000</td>
</tr>
</tbody>
</table>

Wren is considering the following methods of estimating doubtful accounts expense for 1987:

- Based on credit sales at 2%
- Based on accounts receivable at 5%

What amount should Wren charge to doubtful accounts expense under each method?

<table>
<thead>
<tr>
<th>Percentage of</th>
<th>Percentage of</th>
</tr>
</thead>
<tbody>
<tr>
<td>credit sales</td>
<td>accounts receivable</td>
</tr>
<tr>
<td>a. $51,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>b. $51,000</td>
<td>$29,000</td>
</tr>
<tr>
<td>c. $35,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>d. $35,000</td>
<td>$29,000</td>
</tr>
</tbody>
</table>

1M88#52. On October 1, 1987, Dean Company leased office space at a monthly rental of $30,000 for 10 years expiring September 30, 1997. As an inducement for Dean to enter into the lease, the lessor permitted Dean to occupy the premises rent-free from October 1 to December 31, 1987. For the year ended December 31, 1987, Dean should record rent expense of

a. $0  
b. $29,250  
c. $87,750  
d. $90,000
Selected Questions

1N87#42. The following information was taken from Kay Company's accounting records for the year ended December 31, 1986:

- Increase in raw materials inventory: $15,000
- Decrease in finished goods inventory: 35,000
- Raw materials purchased: 430,000
- Direct-labor payroll: 200,000
- Factory overhead: 300,000
- Freight-out: 45,000

There was no work-in-process inventory at the beginning or end of the year. Kay's 1986 cost of goods sold is

- a. $950,000
- b. $965,000
- c. $975,000
- d. $995,000

1N87#43. Korn Company incurred the following costs during 1986:

- Modification to the formulation of a chemical product: $135,000
- Trouble-shooting in connection with breakdowns during commercial production: 150,000
- Design of tools, jigs, molds and dies involving new technology: 170,000
- Seasonal or other periodic design changes to existing products: 185,000
- Laboratory research aimed at discovery of new technology: 215,000

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

1N87#44. Orr Corporation had a realized foreign exchange loss of $13,000 for the year ended December 31, 1986, and must also 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

1N87#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

1N87#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

1N87#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:

- 1/1/86 to 5/14/86 $130,000
- 5/15/86 to 12/31/86 50,000
- 1/1/87 to 1/31/87 15,000

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

1N87#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 amortization should Fay record for the year ended December 31, 1986?
   a. $ 150
   b. $ 250
   c. $1,200
   d. $2,000

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</td>
<td>$ 2,800</td>
<td>$ 3,400</td>
</tr>
<tr>
<td>B</td>
<td>17,000</td>
<td>15,300</td>
</tr>
<tr>
<td>C</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

AP-58
**Selected Questions**

1N87#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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory at 1/1/86</td>
<td>$650,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>3,200,000</td>
</tr>
<tr>
<td>Net sales</td>
<td>4,500,000</td>
</tr>
<tr>
<td>Purchase returns</td>
<td>75,000</td>
</tr>
<tr>
<td>Freight-in</td>
<td>50,000</td>
</tr>
</tbody>
</table>

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 $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>Year</th>
<th>Month</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>March</td>
<td>$—</td>
</tr>
<tr>
<td>1984</td>
<td>September</td>
<td>$24,000</td>
</tr>
<tr>
<td>1985</td>
<td>March</td>
<td>22,000</td>
</tr>
<tr>
<td>1985</td>
<td>September</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

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

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:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>$450,000</td>
</tr>
<tr>
<td>Beginning inventory</td>
<td>170,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>210,000</td>
</tr>
<tr>
<td>Freight-in</td>
<td>50,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>75,000</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment acquired for use in various</td>
<td>$975,000</td>
</tr>
<tr>
<td>research and development projects</td>
<td></td>
</tr>
<tr>
<td>Depreciation on the above equipment</td>
<td>135,000</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>150,000</td>
</tr>
<tr>
<td>Indirect costs appropriately allocated</td>
<td>250,000</td>
</tr>
</tbody>
</table>

The total research and development costs charged in 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash surrender value, 1/1/85</td>
<td>$43,500</td>
</tr>
<tr>
<td>Annual advance premium paid 1/1/85</td>
<td>20,000</td>
</tr>
<tr>
<td>Dividend received 7/1/85</td>
<td>3,000</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable at 12/31/85</td>
<td>$220,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts at 1/1/85</td>
<td>32,000</td>
</tr>
<tr>
<td>Accounts written off as uncollectible at 9/30/85</td>
<td>24,000</td>
</tr>
</tbody>
</table>

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>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition year</td>
<td>1982</td>
</tr>
<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. $18,000
c. $22,000
d. $24,000

1M86#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>Description</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

1M86#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

1M86#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 removable ore estimated by geological surveys at 2,160,000 tons. The property has an estimated value of $360,000 after the ore has been extracted. Huff incurred $1,080,000 of development costs preparing the property for the extraction of ore. During 1984, 270,000 tons were removed and 240,000 tons were sold. For the year ended December 31, 1984, Huff should include what amount of depletion in its cost of goods sold?

a. $360,000
b. $405,000
c. $480,000
d. $540,000

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 at 1/1/84</th>
<th>Credit balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts written off as uncollectible during 1984</td>
<td>11,500</td>
</tr>
<tr>
<td>Accounts receivable at 12/31/84</td>
<td>135,000</td>
</tr>
</tbody>
</table>

For the year ended December 31, 1984, Colt’s bad debt expense would be
a. $ 7,500
b. $10,000
c. $11,500
d. $12,500

1N85#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

1N85#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

1N85#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
Selected Questions

**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#38.** On January 1, 1984, Parke Company borrowed $60,000 from a major customer evidenced by a noninterest bearing note due in three years. Parke agreed to supply the customer’s inventory needs for the loan period at lower than market price. At the 12% imputed interest rate for this type of loan, the present value of the note is $255,000 at January 1, 1984. What amount of interest expense should be included in Parke’s 1984 income statement?

a. $43,200  
b. $35,000  
c. $30,600  
d. $0

**1M85#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>Expense</th>
<th>LCU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation of equipment (related assets)</td>
<td>120,000</td>
</tr>
<tr>
<td>Provision for doubtful accounts</td>
<td>80,000</td>
</tr>
<tr>
<td>Rent</td>
<td>200,000</td>
</tr>
</tbody>
</table>

The exchange rates at various dates are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>LCU</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1984</td>
<td>.40</td>
</tr>
<tr>
<td>Average for year ended 12/31/84</td>
<td>.44</td>
</tr>
<tr>
<td>January 1, 1982</td>
<td>.50</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>Royalty Account</th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid royalties</td>
<td>$55,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Royalties payable</td>
<td>80,000</td>
<td>75,000</td>
</tr>
</tbody>
</table>

During 1984 Cooke remitted royalties of $300,000. In its income statement for the year ended December 31, 1984, Cooke should report royalty expense of

a. $295,000  
b. $305,000  
c. $310,000  
d. $330,000

**1M85#44.** On December 31, 1984, Hurd Company signed an operating lease for a warehouse for ten years at $24,000 per year. Upon execution of the lease, Hurd paid $48,000 covering rent for the first two years. How much should be shown in Hurd’s income statement for the year ended December 31, 1984, as rent expense?

a. $0  
b. $2,000  
c. $24,000  
d. $48,000

**1M85#45.** On January 1, 1983, for past services, Diven Company granted Mary Allen, its president, 5,000 stock appreciation rights which are exercisable immediately and expire three years after date of grant. On exercise, Allen is entitled to receive cash for the excess of the market value of the stock on the exercise date over the market value on the grant date. Allen exercised all of the rights on December 31, 1984. The per share market prices of Diven’s stock were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 1983</td>
<td>25</td>
</tr>
<tr>
<td>December 31, 1983</td>
<td>30</td>
</tr>
<tr>
<td>December 31, 1984</td>
<td>40</td>
</tr>
</tbody>
</table>

As a result of the stock rights, Diven should recognize compensation expense in 1984 of

a. $0  
b. $50,000  
c. $75,000  
d. $200,000

AP-63
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:

- Accounting and legal fees $175,000
- Advertising 150,000
- Freight-out 75,000
- Interest 60,000
- Loss on sale of long-term investment 30,000
- Officers' salaries 225,000
- Rent for office space 180,000
- Sales salaries and commissions 140,000

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

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

Bergen Company purchased factory equipment which was installed and put into service January 3, 1982, at a total cost of $128,000. Salvage value was estimated at $8,000. The equipment is being depreciated over eight years by the double declining balance method. For the year 1983, how much depreciation expense should Bergen record on this equipment?
   a. $22,500
   b. $24,000
   c. $30,000
   d. $32,000

The balance in Mitchell Corporation's foreign exchange loss account was $6,500 at December 31, 1983, before any necessary year-end adjustment relating to the following:

- Mitchell had a $10,000 translation loss resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1983.
- Mitchell had an account payable to an unrelated foreign supplier payable in the local currency of the foreign supplier on January 27, 1984. The U.S. dollar equivalent of the payable was $50,000 on the November 28, 1983, invoice date, and it was $53,000 on December 31, 1983.

In Mitchell's 1983 consolidated income statement, what amount should be included as foreign exchange loss?
   a. $19,500
   b. $16,500
   c. $9,500
   d. $6,500

On January 1, 1983, Baxter Corporation granted John Elliot, 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 Elliot for the next two years. The option is exercisable within a four-year period beginning January 1, 1985. The market price of Baxter's common stock was $35 per share on January 1, 1983, and $37 on December 31, 1983. As a result of the stock option, Baxter should charge compensation expense in 1983 of
   a. $25,000
   b. $35,000
   c. $50,000
   d. $75,000

For the year ended December 31, 1983, Matlock Company incurred the following infrequent losses:

- A loss of $80,000 was incurred on the abandonment of equipment used in the business.
- A loss of $150,000 was sustained as a result of hurricane damage to a warehouse.
- Several factories were shut down during a major strike by employees. Shutdown expenses totaled $170,000.
Selected Questions

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 | 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 September 30 for sales in January through June of the same year. During 1982 and 1983, Apgar remitted the following royalty checks to Seaford:

<table>
<thead>
<tr>
<th>March 31</th>
<th>September 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>$18,000</td>
</tr>
<tr>
<td>1983</td>
<td>15,000</td>
</tr>
</tbody>
</table>

Apgar estimated that sales of the Seaford book would total $110,000 for the last half of 1983. How much royalty expense for this book should Apgar report in its 1983 income statement?
   a. $34,000
   b. $35,000
   c. $36,000
   d. $41,000

1N84#56. On December 1, 1983, Studley Company leased office space for ten years at a monthly rental of $25,000. On the same date Studley paid the lessor the following amounts:

Security deposit (refundable upon expiration of the lease) $ 20,000
First month's rent 25,000
Last month's rent 25,000
Installation of new walls and offices 120,000

For the year ended December 31, 1983, Studley should record expense of
   a. $ 25,000
   b. $ 26,000
   c. $ 45,000
   d. $ 51,000

1M84#34. On September 30, 1983, a fire at Brock Company's only warehouse caused severe damage to its entire inventory. Based on recent history, Brock has a gross profit of 30% of net sales. The following information is available from Brock's records for the nine months ended September 30, 1983:

| Inventory at 1/1/83 | $ 550,000 |
| Purchases          | 3,000,000  |
| Net sales          | 4,000,000  |

A physical inventory disclosed usable damaged goods which Brock estimates can be sold to a jobber for $50,000. Using the gross profit method, the estimated cost of goods sold for the nine months ended September 30, 1983, should be
   a. $2,050,000
   b. $2,485,000
   c. $2,750,000
   d. $2,800,000

1M84#35. The following expenses were among those incurred by Sayre Company during 1983:

| Accounting and legal fees | $160,000 |
| Interest                  | 60,000   |
| Loss on sale of office equipment | 25,000 |
| Rent for office space     | 200,000  |

One-quarter of the rented premises is occupied by the sales department. How much of the expenses listed above should be included in Sayre's general and administrative expenses for 1983?
   a. $310,000
   b. $335,000
   c. $360,000
   d. $370,000

1M84#36. Blackwood Corporation had a $20,000 translation loss adjustment resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1983. Blackwood also had a receivable from a foreign customer which was payable in the local currency of the foreign customer. On December 31, 1982, this receivable for 100,000 local currency units (LCU) was appropriately included in Blackwood's balance sheet at $55,000. When the receivable was collected on February 10, 1983, the exchange rate was 2 LCU to $1. In Blackwood's 1983 consolidated income statement, what amount should be included as foreign exchange loss?
   a. $0
   b. $ 5,000
   c. $20,000
   d. $25,000

AP-65
Accounting Practice

1M84#38. During 1983 Mann Company developed a new product to be marketed beginning January 1, 1984. The following costs, incurred during 1983 in the development of this product, are expected to be recovered by December 31, 1983:

<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Cost</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>
</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

1M84#39. On January 1, 1983, Cody Company as lessee signed a ten-year noncancellable 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:

- Interest expense: $120,000
- Loss on disposal of noncurrent investment: 80,000
- Writedown of plant and equipment to estimated realizable value: 60,000

In its income statement for 1983, how much should Martin report as total extraordinary items?

a. $0
b. $140,000
c. $180,000
d. $200,000

1M84#52. On January 1, 1983, Kipling Company paid $12,000 to White Properties as a lease bonus to obtain a four-year nonrenewable lease on premises beginning on that date. Additionally, Kipling will pay $14,000 annual rent on each December 31 throughout the term of the lease. For the year ended December 31, 1983, Kipling should report rent expense at

a. $12,000
b. $14,000
c. $17,000
d. $26,000

C. Provision for Income Tax

In November 1987, the FASB issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes," superseding APB Opinion No. 11, "Accounting for Income Taxes." Accordingly, all previous examination items covered by APB Opinion No. 11 have been deleted.

D. Recurring Versus Nonrecurring Transactions and Events

1M87#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

1M87#49. On December 31, 1986, King Company 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 $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

<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

<table>
<thead>
<tr>
<th>Other income</th>
<th>Extraordinary gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $200,000</td>
<td>$0</td>
</tr>
<tr>
<td>b. $140,000</td>
<td>$0</td>
</tr>
<tr>
<td>c. $ 90,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>d. $ 90,000</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

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

1M86#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
   b. $300,000
   c. $350,000
   d. $500,000

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. $800,000

1M85#46. Farr, Inc., is disposing of a segment of its business. At the measurement date the net loss from the disposal is estimated to be $675,000. Included in this $675,000 are severance pay of $50,000 and employee relocation costs of $25,000, both of which are
Accounting Practice

directly associated with the decision to dispose of the segment, and estimated operating loss of the segment to the disposal date of $100,000. A loss of $125,000 from operations from the beginning of the year to the measurement date is not included in the $675,000 estimated disposal loss. Ignoring income taxes, how much should be reported on Farr's income statement as the total loss under the heading "discontinued operations"?

a. $225,000
b. $625,000
c. $650,000
d. $800,000

1M85#48. Trent Company had net income of $700,000 for the year ended December 31, 1984, after giving effect to the following events which occurred during the year:

- The decision was made January 2 to discontinue the plastics manufacturing segment.
- The plastics manufacturing segment was sold June 30.
- Operating loss from January 1 to June 30 for the plastics manufacturing segment amounted to $60,000 before tax benefit.
- Plastics manufacturing equipment with a book value of $350,000 was sold for $200,000.

Trent's tax rate was 40% for 1984. For the year ended December 31, 1984, Trent's after-tax income from continuing operations was

a. $574,000
b. $700,000
c. $784,000
d. $826,000

1M84#42. Carr Company is indebted to Apex Company under a $700,000, 12%, four-year note dated December 31, 1980. Annual interest of $84,000 was paid on December 31, 1981, and 1982. During 1983 Carr experienced financial difficulties and is likely to default on the note and interest unless concessions are made. On December 31, 1983, Apex agreed to restructure the debt as follows:

- Interest for 1983 was reduced from $84,000 to $40,000 payable on January 31, 1984.
- Interest for 1984 was waived.
- The $700,000 principal amount was reduced to $600,000.

Ignoring income taxes, how much should Carr report as extraordinary gain on debt restructuring in its income statement for the year ended December 31, 1983?

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

1M84#44. On July 1, 1983, Tyler Corporation approved a formal plan to sell its plastics division, considered a segment of the business. The sale will occur in the first three months of 1984. The division had an operating loss of $400,000 for the six months ended December 31, 1983, and expects to incur a loss of $200,000 for the first quarter of 1984. The sales price is $22,000,000, and the carrying value at the date of sale should be $20,000,000. Tyler's effective tax rate for 1983 is 40%. For the year ended December 31, 1983, how much gain should Tyler report on disposal of the plastics division?

a. $0
b. $840,000
c. $1,080,000
d. $1,200,000

E. Accounting Changes

1N87#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

1M84#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 depre-
associated 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 depreciation 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 financial statements:

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.

1N85#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

1N85#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 financial statements:

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 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

F. Earnings Per Share

1N87#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. 725,000
   b. 780,000
   c. 885,000
   d. 930,000

1N87#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

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></th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<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**

<table>
<thead>
<tr>
<th></th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$100,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>$30,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$130,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>$220,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$140,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$620,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>$980,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Total liabilities and stockholders’ equity</td>
<td>$1,110,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

AP-70
INCOME STATEMENTS
For the Year Ended December 31, 1986

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

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</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>10% convertible bonds, convertible into 20,000 shares of common</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

During 1984, Parke paid $45,000 dividends on the preferred stock, which is considered a common stock equivalent. The convertible bonds are not considered common stock equivalents. Parke’s net income for 1984 was $980,000 and the income tax rate was 40%.

54. For the year ended December 31, 1984, the primary earnings per share is
   a. $10.89
   b. $10.39
   c. $ 8.17
   d. $ 7.79

55. For the year ended December 31, 1984, the fully diluted earnings per share is
   a. $9.82
   b. $8.29
   c. $7.71
   d. $7.43

1N85#51. Mann, Inc., had 300,000 shares of common stock issued and outstanding at December 31, 1983. On July 1, 1984, an additional 50,000 shares of common stock were issued for cash. Mann also had unexercised stock options to purchase 40,000 shares of common stock at $15 per share outstanding at the beginning and end of 1984. The average market price of Mann’s common stock was $20 during 1984. What is the number of shares that should be used in computing primary earnings per share for the year ended December 31, 1984?
   a. 325,000
   b. 335,000
   c. 360,000
   d. 365,000

1N84#57. Fay Corporation’s capital structure at December 31, 1982, was as follows

<table>
<thead>
<tr>
<th>Shares issued and outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
</tr>
<tr>
<td>Nonconvertible preferred stock</td>
</tr>
</tbody>
</table>

On October 1, 1983, Fay issued a 10% stock dividend on its common stock, and paid $100,000 cash dividends on the preferred stock. Net income for the year ended December 31, 1983, was $960,000. Fay’s 1983 earnings per common share should be
   a. $3.91
   b. $4.10
   c. $4.36
   d. $4.68

1N84#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

1N84#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

AP-72
Selected Questions

VI. Other Financial Topics

A. Disclosures In Notes to the Financial Statements

1M88#46. A personal injury liability suit for $500,000 was brought against Ashe Corp. during 1987. Ashe's management and counsel concluded that it is reasonably possible that Ashe will be responsible for damages, and that $150,000 is a reasonable estimate of the damages. In Ashe's December 31, 1987 financial statements, how should this item be reported?
   a. No disclosure in the financial statements or accrual is required.
   b. As an accrued liability of $50,000 and as a disclosure in the financial statements indicating the exposure to an additional amount of loss up to $350,000.
   c. As an accrued liability of $150,000 only.
   d. As a disclosure only in the financial statements indicating the possible loss of $150,000.

C. Nonmonetary Transactions

1M88#50. On March 31, 1988, Winn Company traded in an old machine having a carrying amount of $16,800, and paid a cash difference of $6,000 for a new machine having a total cash price of $20,500. On March 31, 1988, what amount of loss should Winn recognize on this exchange?
   a. $0  
   b. $2,300  
   c. $3,700  
   d. $6,000

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>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying amount of the car</td>
<td>$30,000</td>
</tr>
<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.

1N85#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#43. 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
Accounting Practice

market value of $110 per share on the date of the exchange. At what amount should the land be recorded on Brit’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>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of old computer</td>
<td>$60,000</td>
</tr>
<tr>
<td>Accumulated depreciation—old computer</td>
<td>$20,000</td>
</tr>
<tr>
<td>Fair value of old computer</td>
<td>$30,000</td>
</tr>
<tr>
<td>List price of new model</td>
<td>$80,000</td>
</tr>
<tr>
<td>Trade-in allowance for old computer</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

How much loss should Lara immediately recognize on this trade-in?

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

1N84#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

D. Interim Financial Statements

1N88#54. On March 15, 1987, Rex Company paid property taxes of $180,000 on its factory building for calendar year 1987. On April 1, 1987, Rex made $300,000 in unanticipated repairs to its plant equipment. The repairs will benefit operations for the remainder of the calendar year. What total amount of

these expenses should be included in Rex’s quarterly income statement for the three months ended June 30, 1987?

a. $75,000
b. $145,000
c. $195,000
d. $345,000

1N87#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>Description</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>175,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>1,705,000</td>
<td></td>
</tr>
<tr>
<td>Estimated normal shoplifting losses</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Markdowns, net</td>
<td>125,000</td>
<td></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

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 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>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 2/1/83</td>
<td>$ 70,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>350,000</td>
</tr>
<tr>
<td>Additional markups</td>
<td>90,000</td>
</tr>
<tr>
<td>Sales</td>
<td>600,000</td>
</tr>
<tr>
<td>Estimated normal shoplifting losses</td>
<td>10,000</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

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

1M88#55. Bart Corp.'s accounting records had the following data relating to cost of goods sold for 1987:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/87</td>
<td>$530,000</td>
</tr>
<tr>
<td>Production during 1987</td>
<td>2,790,000</td>
</tr>
<tr>
<td>Inventory, 12/31/87</td>
<td>3,320,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$2,375,000</td>
</tr>
</tbody>
</table>

The current cost per inventory unit was $30 at January 1, 1987, and $36 at December 31, 1987. In Bart's voluntary supplementary information for 1987, the cost of goods sold restated into average current cost would be

a. $2,490,000
b. $2,520,000
c. $2,580,000
d. $2,640,000

1N87

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>1986</th>
<th>Historical costs</th>
<th>Units purchased</th>
<th>Units sold</th>
</tr>
</thead>
<tbody>
<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><strong>$2,015,000</strong></td>
<td><strong>31,000</strong></td>
<td><strong>30,000</strong></td>
<td></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

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. $384,000  
   b. $336,000  
   c. $260,000  
   d. $232,000

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:

- Land (purchased in 1983) $120,000
- Investment in nonconvertible bonds (purchased in 1983, and expected to be held to maturity) $60,000
- Long-term debt 80,000

The average Consumer Price Index was 100 for 1983, and 110 for 1984. In a supplementary constant dollar balance sheet (adjusted for changing prices) at December 31, 1984, these selected account balances should be shown 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>$1,060,000</td>
</tr>
<tr>
<td>Production during 1984</td>
<td>$5,580,000</td>
</tr>
<tr>
<td>Inventory, 12/31/84</td>
<td>$6,640,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$4,750,000</td>
</tr>
</tbody>
</table>

Wilson estimates that the current cost per unit of inventory was $58 at January 1, 1984, and $72 at December 31, 1984. In Wilson's supplementary information restated into average current cost, the cost of goods sold for 1984 should be:
   a. $4,640,000  
   b. $5,040,000  
   c. $5,200,000  
   d. $5,760,000

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:

- Demand bank deposits $500,000
- Net long-term receivables 300,000
- Deferred income tax charges 100,000
- Bonds payable (due in 1988) $200,000
- Sales (made evenly throughout the year) 990,000
During 1983, the average price index was 140. The bonds were issued in 1978 when the price index was 120. Sosa wishes to present December 31, 1983, constant dollar financial statements in end-of-year dollars.

9. What fraction should be used to adjust bonds payable for price-level changes?
   a. 140/160
   b. 160/160
   c. 160/140
   d. 160/120

10. What fraction should be used to adjust sales for price-level changes?
    a. 160/160
    b. 160/150
    c. 160/140
    d. 140/160

F. Gain Contingencies

1M85#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

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
Accounting Practice

G. Segments and Lines of Business

1M87#59. Cord Corporation discloses supplementary industry segment information for its two reportable segments. Data for 1986 are available as follows:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales</th>
<th>Traceable operating expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>E</td>
<td>$750,000</td>
<td>$325,000</td>
</tr>
<tr>
<td>W</td>
<td>$250,000</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

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

1M86#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:

- Sales to unaffiliated customers $1,000,000
- Intersegment sales of products similar to those sold to unaffiliated customers 300,000
- Interest earned on loans to mother industry segments 20,000

Hay and all of its divisions are engaged solely in manufacturing operations. Hay has a reportable segment if that segment's revenue exceeds a. $100,000
b. $102,000
c. $130,000
d. $132,000

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

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales</th>
<th>Traceable operating expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>E</td>
<td>$500,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>F</td>
<td>400,000</td>
<td>250,000</td>
</tr>
<tr>
<td>G</td>
<td>300,000</td>
<td>175,000</td>
</tr>
<tr>
<td></td>
<td>$1,200,000</td>
<td>$725,000</td>
</tr>
</tbody>
</table>

Additional 1984 expenses, not included above, are as follows:
- Indirect operating expenses $180,000
- General corporate expenses $120,000

Appropriate common expenses are allocated to segments based on the ratio of a segment's sales to total sales. What should be the operating profit for segment G for 1984?
  a. $125,000
  b. $80,000
  c. $65,000
  d. $50,000

1M85#55. Mill, Inc., reports operating profit as to industry segments in its supplementary financial information annually. The following data are available for 1984:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales</th>
<th>Traceable costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$1,500,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>B</td>
<td>1,000,000</td>
<td>450,000</td>
</tr>
<tr>
<td>C</td>
<td>500,000</td>
<td>250,000</td>
</tr>
<tr>
<td></td>
<td>$3,000,000</td>
<td>$1,600,000</td>
</tr>
</tbody>
</table>

AP-78
Additional expenses not included above are as follows:

<table>
<thead>
<tr>
<th>Expense Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indirect operating expenses</td>
<td>$480,000</td>
</tr>
<tr>
<td>General corporate expenses</td>
<td>300,000</td>
</tr>
<tr>
<td>Other expense (net)</td>
<td>96,000</td>
</tr>
</tbody>
</table>

Mill allocates common costs based on the ratio of a segment's sales to total sales. What should be the operating profit for segment A for 1984?

- a. $162,000
- b. $210,000
- c. $312,000
- d. $360,000

2N84#4. Daly Corporation's sales to unaffiliated customers were $3,000,000 for the year ended December 31, 1983. In addition, there were $400,000 of intersegment sales and transfers among Daly's four manufacturing divisions operating in different industries. Daly's reportable industry segments are those divisions with revenues of at least:

- a. $40,000
- b. $100,000
- c. $300,000
- d. $340,000

2N84#5. Orna Corp. operates in six different industries, each of which is appropriately regarded as a reportable segment. Orna's 1983 combined sales for all segments aggregated $10,000,000. Segment No. 4 had sales of $2,000,000 and traceable costs of $900,000. Combined common costs for all segments totaled $3,000,000. Common costs are allocated among the six segments on the basis of each segment's percentage of Orna's total sales, an acceptable allocation method. How much should be reported as Segment No. 4's operating income for 1983?

- a. $500,000
- b. $1,100,000
- c. $1,220,000
- d. $1,400,000

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

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales</th>
<th>Traceable Costs</th>
<th>Allocable Costs</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?

- a. $20,000
- b. $24,000
- c. $36,000
- d. $48,000

H. Employee Benefits

1N87 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:

- 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>

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

1N84#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

I. Analysis of Financial Statements

1M86#57. Selected information for Cain Corp. for the year ended December 31, 1987 follows:

Average days' sales in inventories 124
Average days' sales in accounts receivable 48

The average number of days in the operating cycle for 1987 was
   a. 172
   b. 124
   c. 86
   d. 76

1N87#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.

1N87#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:

Stockholders' equity at 12/31/86 $4,500,000
Net income year ended 12/31/86 1,200,000
Dividends on preferred stock year ended 12/31/86 300,000
Market price per share of common stock at 12/31/86 72

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.

1M87

Items 54 and 55 are based on the following data:

Drew Company
Selected Financial Data

<table>
<thead>
<tr>
<th>As of December 31,</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$75,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</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 securities</td>
<td>40,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Land and building (net)</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Mortgage payable-current portion</td>
<td>30,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>120,000</td>
<td>110,000</td>
</tr>
<tr>
<td>Short-term notes payable</td>
<td>50,000</td>
<td>70,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year Ended December 31,</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.
Selected Questions

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

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>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders' Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
</tr>
<tr>
<td>Accounts payable</td>
</tr>
<tr>
<td>Accrued liabilities</td>
</tr>
<tr>
<td>Total current liabilities</td>
</tr>
</tbody>
</table>

| 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 |

<table>
<thead>
<tr>
<th>Total liabilities and stockholders' equity</th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$1,110,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

### 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 ascertamblable.

- 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

AP-81
1N86

Items 56 and 57 are based on the following data:

**Apex Corporation**

**SELECTED FINANCIAL DATA**

**Year Ended December 31, 1985**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income</td>
<td>$900,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>100,000</td>
</tr>
<tr>
<td>Income before income tax</td>
<td>800,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>320,000</td>
</tr>
<tr>
<td>Net income</td>
<td>480,000</td>
</tr>
<tr>
<td>Preferred stock dividends</td>
<td>200,000</td>
</tr>
<tr>
<td>Net income available to common stockholders</td>
<td>$280,000</td>
</tr>
<tr>
<td>Common stock dividends</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

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.

1N86#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

2M86

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

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (all on credit)</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>900,000</td>
</tr>
<tr>
<td>Net income</td>
<td>150,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Inventory at end of year</td>
<td>200,000</td>
</tr>
<tr>
<td>Accounts receivable at beginning of year</td>
<td>600,000</td>
</tr>
<tr>
<td>Accounts receivable at end of year</td>
<td>400,000</td>
</tr>
<tr>
<td>Stockholders' equity at end of year:</td>
<td></td>
</tr>
<tr>
<td>Common stock outstanding (unchanged during year) — 300,000 shares at par</td>
<td></td>
</tr>
<tr>
<td>of $1 per share</td>
<td>$300,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>500,000</td>
</tr>
</tbody>
</table>

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.

1N85#60. Selected information from the accounting records of Kay Company is as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales for 1984</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Cost of goods sold for 1984</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Inventory at 12/31/83</td>
<td>360,000</td>
</tr>
<tr>
<td>Inventory at 12/31/84</td>
<td>312,000</td>
</tr>
</tbody>
</table>

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.

2NB4#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
Selected Questions

2N84#7 The following information pertains to Bass Co. for 1983:

| Merchandise purchased | $1,800,000 |
| Cost of goods sold      | 2,000,000  |
| Inventory at December 31, 1983 | 400,000 |

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>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Preferred stock</td>
</tr>
<tr>
<td>Common stock</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td>Net income for year ended</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%

J. Development Stage Enterprises

1M88

Items 58 and 59 are based on the following information:

Towne Systems Corp. was a development stage enterprise from October 10, 1985 (inception) to December 31, 1986. The year ended December 31, 1987 is the first year in which Towne is an established operating enterprise. The following are among the costs incurred by Towne:

<table>
<thead>
<tr>
<th>For the period 10/10/85 to 12/31/86</th>
<th>For the year ended 12/31/87</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leasehold improvements, equipment, and furniture</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Security deposits</td>
<td>60,000</td>
</tr>
<tr>
<td>Research and development</td>
<td>750,000</td>
</tr>
<tr>
<td>Laboratory operations</td>
<td>175,000</td>
</tr>
<tr>
<td>General and administrative</td>
<td>250,000</td>
</tr>
</tbody>
</table>

For the period ended December 31, 1986, what total amount of the costs incurred should Towne have capitalized?

a. $1,060,000
b. $1,810,000
c. $1,985,000
d. $2,235,000

59. For the year ended December 31, 1987, what total amount of the costs incurred should Towne have capitalized?

a. $875,000
b. $615,000
c. $165,000
d. $150,000

K. Personal Financial Statements

1M88#60. On December 31, 1987, Mr. and Mrs. Blake owned a parcel of land held as an investment. The land was purchased for $95,000 in 1980, and was encumbered by a mortgage with a principal balance of $60,000 at December 31, 1987. On this date the fair value of the land was $150,000. In the Blakes’ December 31, 1987 personal statement of financial condition, at what amount should the land investment and mortgage payable be reported?

<table>
<thead>
<tr>
<th>Land investment</th>
<th>Mortgage payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $150,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>b. $ 95,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>c. $ 90,000</td>
<td>$0</td>
</tr>
<tr>
<td>d. $ 35,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

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.

AP-83
• 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?

a. $90,000
b. $85,000
c. $75,000
d. $10,000

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

a. $470,000
b. $500,000
c. $715,000
d. $745,000

58. In the Tafts' December 31, 1984, personal statement of financial condition, the liabilities listed above should be reported at a total amount of

a. $58,000
b. $72,000
c. $258,000
d. $272,000

1M85#50. Mr. & Mrs. Dean require a personal statement of financial condition as of December 31, 1984. Included in their assets at this date are the following:

• A $300,000 whole life insurance policy (on Mr. Dean) having a cash value of $43,000 at December 31, 1984, subject to a $37,000 loan payable to the insurance company.

• A residence purchased in 1980 at a cost of $150,000. Similar homes in the area are currently selling at approximately $175,000.

In the Deans' December 31, 1984, personal statement of financial condition, the above assets should be reported at a total amount of

a. $218,000
b. $193,000
c. $181,000
d. $156,000

1M84#57. Mr. & Mrs. Carson are applying for a bank loan and the bank has requested a personal statement of financial condition as of December 31, 1983. Included in their assets at this date are the following:

• 1,000 shares of Alden Corporation common stock purchased in 1980 at a cost of $50,000. The quoted market value of the stock was $75 per share on December 31, 1983.

• A residence purchased in 1981 at a cost of $120,000. Improvements costing $15,000 were made in 1982. Unimproved similar homes in the area are currently selling at approximately the same price levels as in 1981.
In the Carsons’ December 31, 1983, personal statement of financial condition, the above assets should be reported at a total amount of

a. $170,000  
b. $185,000  
c. $195,000  
d. $210,000

L. Combined Financial Statements

1M88#53. Mr. and Mrs. Gasson own 100% of the common stock of Able Corp. and 90% of the common stock of Baker Corp. Able previously paid $4,000 for the remaining 10% interest in Baker. The condensed December 31, 1987 balance sheets of Able and Baker are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Able</th>
<th>Baker</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$600,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$200,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>100,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>300,000</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>$600,000</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

In a combined balance sheet of the two corporations at December 31, 1987, what amount should be reported as total stockholders’ equity?

a. $430,000  
b. $426,000  
c. $403,000  
d. $400,000

1M87#60. Selected information for two unconsolidated subsidiaries of Ray Company taken from their pre-closing trial balances at December 31, 1986, is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Ash Company</th>
<th>Bix Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/86</td>
<td>Dr. (Cr.)</td>
<td>Dr. (Cr.)</td>
</tr>
<tr>
<td>Purchases</td>
<td>$120,000</td>
<td>$ —</td>
</tr>
<tr>
<td>Shipments to Bix</td>
<td>190,000</td>
<td>85,000</td>
</tr>
<tr>
<td>Shipments from Ash</td>
<td>(80,000)</td>
<td>—</td>
</tr>
<tr>
<td>Unrealized intercompany inventory profit</td>
<td>(20,000)</td>
<td>—</td>
</tr>
</tbody>
</table>

Additional data relating to the inventory at December 31, 1986, are as follows:

- $125,000 inventory acquired from outside parties
- $25,000 Bix inventory acquired from Ash
- $30,000 Bix inventory
- $25,000 from outside parties

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>
<th>Loans</th>
<th>Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>$0</td>
<td>$300,000</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
<td>$300,000</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

- Factory overhead 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

2M86#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

2M85#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>Utilities</td>
</tr>
</tbody>
</table>

The amount of maintenance department costs distributed to Producing - A department for June 1985 was:
   a. $8,000
   b. $8,800
   c. $10,000
   d. $11,000

2M85

Items 2 and 3 are based on the following data:

Blum Corp. manufactures plastic coated metal clips. The following were among Blum's 1984 manufacturing costs:

<table>
<thead>
<tr>
<th>Wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine operators</td>
</tr>
<tr>
<td>Maintenance workers</td>
</tr>
<tr>
<td>Factory foremen</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Materials used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metal wire</td>
</tr>
<tr>
<td>Lubricant for oiling machinery</td>
</tr>
<tr>
<td>Plastic coating</td>
</tr>
</tbody>
</table>

2. Blum's 1984 direct labor amounted to:
   a. $200,000
   b. $230,000
   c. $290,000
   d. $320,000

3. Blum's 1984 direct materials amounted to:
   a. $890,000
   b. $880,000
   c. $510,000
   d. $500,000

2M84#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.

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>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process, April 1</td>
</tr>
<tr>
<td>(60% complete as to conversion cost)</td>
</tr>
<tr>
<td>Started in April</td>
</tr>
<tr>
<td>Completed</td>
</tr>
</tbody>
</table>

Work-in-process, April 30 |
(75% complete as to conversion cost) | 8,000 |

Under the weighted average method, the equivalent units for conversion cost are

- a. 26,000
- b. 25,000
- c. 24,200
- d. 21,800

2M86#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

2M86#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. 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>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
</tr>
<tr>
<td>30</td>
</tr>
<tr>
<td>30</td>
</tr>
<tr>
<td>30</td>
</tr>
<tr>
<td>30</td>
</tr>
</tbody>
</table>

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#28. For the month of April, Thorp Co.’s records disclosed the following data relating to direct labor:

- Actual cost $10,000
- Rate variance 1,000 favorable
- Efficiency variance 1,500 unfavorable
- Standard cost $9,500

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:

<table>
<thead>
<tr>
<th>Material</th>
<th>Cost per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials</td>
<td>$1</td>
</tr>
<tr>
<td>Conversion</td>
<td>3</td>
</tr>
<tr>
<td>Transferred-in</td>
<td>5</td>
</tr>
</tbody>
</table>

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>Account</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, April 1</td>
<td>$24,000</td>
</tr>
<tr>
<td>Direct materials (including transferred-in cost)</td>
<td>80,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>60,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>54,000</td>
</tr>
<tr>
<td>Transferred to finished goods</td>
<td>(200,000)</td>
</tr>
</tbody>
</table>

Ace applies factory overhead at 90% of direct labor cost. Job No. 125, which was the only job in process at April 30, has been charged with factory overhead of $4,500. Bow’s cost to manufacture Product Zee is $3.00 per unit, which is sold to Ace for $5.00 per unit and to unrelated customers for $6.00 per unit.

15. Direct materials (including transferred-in cost) charged to Job No. 125 amounted to:

- a. $ 5,000
- b. $ 8,500
- c. $13,500
- d. $18,000

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:

<table>
<thead>
<tr>
<th>Cost</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>

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

2M88 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>Cost</th>
<th>Cost per Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable</td>
<td>$6 per unit</td>
</tr>
<tr>
<td>Fixed</td>
<td>8 per unit</td>
</tr>
</tbody>
</table>

The following information pertains to the month of March 1986:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units actually produced</td>
<td>38,000</td>
</tr>
<tr>
<td>Actual direct labor hours</td>
<td>80,000</td>
</tr>
</tbody>
</table>

Actual overhead incurred:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable</td>
<td>$250,000</td>
</tr>
<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

Selected Questions

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard quantity of materials</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.

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#30. Lee Co. produces two joint products, BEX and ROM. Joint production costs for June 1986 were $30,000. During June 1986 further processing costs beyond the split-off point, needed to convert the products into salable form, were $25,000 and $35,000 for 1,600 units of BEX and 800 units of ROM, respectively. BEX sells for $50 per unit, and ROM sells for $100 per unit. Lee uses the net realizable value method for allocating joint product costs. For June 1986, the joint costs allocated to product BEX were
   a. $20,000
   b. $16,500
   c. $13,500
   d. $10,000

2N86#37. Dex Co. had the following production for the month of June:

<table>
<thead>
<tr>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-process at June 1</td>
</tr>
<tr>
<td>Started during June</td>
</tr>
<tr>
<td>Completed and transferred  to finished goods</td>
</tr>
<tr>
<td>Abnormal spoilage incurred</td>
</tr>
<tr>
<td>Work-in-process at June 30</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 produced</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>$262,000</td>
</tr>
<tr>
<td>Sales value at split-off</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 split-off approach. The joint costs allocated to product X were
   a. $75,000
   b. $100,800
   c. $150,000
   d. $168,000
Accounting Practice

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 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

2M86#36. Abel Corp. manufactures a product that yields the by-product, “Yum.” The only costs associated with Yum are selling costs of $.10 per unit sold. Abel accounts for sales of Yum by deducting Yum’s separable costs from Yum’s sales, and then deducting 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.

2M86#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

2M87#4. Tish Co. produces two joint products, Ebo and Gel. Joint production costs for May 1985 were $30,000. During May 1985 further processing costs beyond the split-off point, needed to convert the products into salable form, were $16,000 and $24,000 for 1,600 units of Ebo and 800 units of Gel, respectively. Ebo sells for $25 per unit and Gel sells for $50 per unit. Tish uses the net realizable value method for allocating joint product costs. What were the joint costs allocated to Ebo for May 1985?
   a. $10,000
   b. $12,000
   c. $18,000
   d. $20,000

2M85#5. In its July 1985 production, Gage Corp., which does not use a standard cost system, incurred total production costs of $800,000, of which Gage attributed $30,000 to normal spoilage and $20,000 to abnormal spoilage. Gage should account for this spoilage as
   a. Inventoriable cost of $30,000 and period cost of $20,000.
   b. Period cost of $30,000 and inventoriable cost of $20,000.
   c. Inventoriable cost of $50,000.
   d. Period cost of $50,000.

2M85#6. Lane Co. produces main products Kul and Wu. The process also yields by-product Zef. Net realizable value of by-product Zef is subtracted from joint production cost of Kul and Wu. The following information pertains to production in July 1985 at a joint cost of $54,000:

<table>
<thead>
<tr>
<th>Product</th>
<th>Units produced</th>
<th>Market value</th>
<th>Additional cost after split-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kul</td>
<td>1,000</td>
<td>$40,000</td>
<td>$0</td>
</tr>
<tr>
<td>Wu</td>
<td>1,500</td>
<td>$35,000</td>
<td>0</td>
</tr>
<tr>
<td>Zef</td>
<td>500</td>
<td>$7,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>

If Lane uses the net realizable value method for allocating joint cost, how much of the joint cost should be allocated to product Kul?
   a. $18,800
   b. $20,000
   c. $26,667
   d. $27,342

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:

| Direct materials | $10,000 |
| Direct labor     | 20,000  |
| Variable manufacturing overhead | 5,000 |
| Variable selling and general | 3,000 |
| Fixed manufacturing overhead | 9,000 |
| Fixed selling and general | 4,000 |
| Total | $51,000 |

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:

| Direct materials and direct labor | $500,000 |
| Depreciation of manufacturing equipment | 70,000 |
| Depreciation of factory building | 40,000 |
| Janitor's wages for cleaning factory premises | 15,000 |

AP-90
How much of these costs should be inventoried for external reporting purposes?

- $625,000
- $610,000
- $585,000
- $500,000

2N84

Items 19 and 20 are based on the following data:

Lina Co. produced 100,000 units of Product Zee during the month of June. Costs incurred during June were as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials used</td>
<td>$100,000</td>
</tr>
<tr>
<td>Direct labor used</td>
<td>80,000</td>
</tr>
<tr>
<td>Variable manufacturing overhead</td>
<td>40,000</td>
</tr>
<tr>
<td>Fixed manufacturing overhead</td>
<td>50,000</td>
</tr>
<tr>
<td>Variable selling and general expenses</td>
<td>12,000</td>
</tr>
<tr>
<td>Fixed selling and general expenses</td>
<td>45,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$327,000</strong></td>
</tr>
</tbody>
</table>

19. What was Product Zee’s unit cost under absorption costing?

- $3.27
- $2.70
- $2.20
- $1.80

20. What was Product Zee’s unit cost under variable (direct) costing?

- $2.82
- $2.70
- $2.32
- $2.20

F. Budgeting and Flexible Budgeting

2M87#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>
</tr>
</thead>
<tbody>
<tr>
<td>Actual inventory at April 1</td>
</tr>
<tr>
<td>Work-in-process</td>
</tr>
<tr>
<td>Finished goods</td>
</tr>
<tr>
<td>Budgeted inventory at April 30</td>
</tr>
<tr>
<td>Work-in-process (75% processed)</td>
</tr>
<tr>
<td>Finished goods</td>
</tr>
</tbody>
</table>

How many equivalent units of production did Glo budget for April 1987?

- 126,500
- 125,500
- 123,500
- 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><strong>Totals</strong></td>
<td><strong>$450,000</strong></td>
</tr>
<tr>
<td><strong>Fixed</strong></td>
<td><strong>$90,000</strong></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

- $525,000
- $540,000
- $615,000
- $630,000

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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$100,000</td>
</tr>
<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 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.

34. Before the purchase of the $30,000 machine, Alo’s breakeven point in sales dollars was

- $16,667
- $25,000
- $30,000
- $70,000

AP-91
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,</td>
<td>30,000</td>
<td>48,000</td>
</tr>
<tr>
<td>and administrative</td>
<td></td>
<td></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

How much will be contributed to profit before income taxes by the 1,001st unit sold?
   a. $650
   b. $500
   c. $150
   d. $0

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 price</th>
<th>Variable costs</th>
</tr>
</thead>
<tbody>
<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

Kent Co.'s 1985 operating percentages were as follows:

<table>
<thead>
<tr>
<th></th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>50%</td>
</tr>
<tr>
<td>Fixed</td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>10%</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>20%</td>
</tr>
<tr>
<td>Fixed</td>
<td>15%</td>
</tr>
<tr>
<td>Operating income</td>
<td>5%</td>
</tr>
</tbody>
</table>

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

Items 14 and 15 are based on the following data:

The following information pertains to Rica Company:

<table>
<thead>
<tr>
<th></th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (50,000 units)</td>
<td></td>
</tr>
<tr>
<td>Direct materials and direct labor</td>
<td>300,000</td>
</tr>
<tr>
<td>Factory overhead:</td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>40,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>70,000</td>
</tr>
<tr>
<td>Selling and general expenses:</td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>10,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>60,000</td>
</tr>
</tbody>
</table>

14. How much was Rica's break-even point in number of units?
   a. 9,848
   b. 10,000
   c. 18,571
   d. 26,000

15. What was Rica's contribution margin ratio?
   a. 66%
   b. 65%
   c. 59%
   d. 35%

AP-92
Selected Questions

H. Capital Budgeting Techniques

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>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$100,000</td>
</tr>
<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>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.

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.

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>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

2M85#13. Oran Co. has the opportunity to invest in a two-year project which is expected to produce cash flows from operations, net of income taxes, of $100,000 in the first year and $200,000 in the second year. Oran requires an internal rate of return of 20%. The present...
value of $1 for one period at 20% is 0.833 and for two periods at 20% is 0.694. For this project, Oran should be willing to invest immediately a maximum of
a. $283,300
b. $249,900
c. $222,100
d. $208,200

2N84/18. Axel Corp. is planning to buy a new machine with the expectation that this investment should earn a discounted rate of return of at least 15%. This machine, which costs $150,000, would yield an estimated net cash flow of $30,000 a year for 10 years, after income taxes. In order to determine the net present value of buying the new machine, Axel should first multiply the $30,000 by which of the following factors?
   a. 20.304 (Future amount of an ordinary annuity of $1).
   b. 5.019 (Present value of an ordinary annuity of $1).
   c. 4.046 (Future amount of $1).
   d. 0.247 (Present value of $1).

I. Performance Analysis

2M87

Items 34 through 38 are based on the following selected data pertaining to Mar Co.’s Alo Division for 1986:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$100,000</td>
</tr>
<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 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

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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></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,</td>
<td></td>
</tr>
<tr>
<td>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.

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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$300,000</td>
</tr>
<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%
Selected Questions

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>

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%

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. Ral 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.:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$4</td>
</tr>
<tr>
<td>Direct labor</td>
<td>10</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>40</td>
</tr>
<tr>
<td>Standard cost per unit</td>
<td>$54</td>
</tr>
</tbody>
</table>

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
Accounting Practice

2M87#30. The following data appeared in the accounting records of a retail store for the year ended December 31, 1986:

Sales $150,000
Purchases 70,000
Inventories:
  January 1 35,000
  December 31 50,000
Sales commissions 5,000

How much was the gross margin?
  a. $65,000
  b. $75,000
  c. $90,000
  d. $95,000

2M87
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>Number of hours per 1,000 papers processed</th>
<th>Normal number of papers processed per year</th>
<th>Wage rate per 1,000 papers</th>
<th>Standard variable cost of processing 1,500,000 papers</th>
<th>Fixed costs per year</th>
</tr>
</thead>
<tbody>
<tr>
<td>150</td>
<td>1,500,000</td>
<td>$600</td>
<td>$900,000</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

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

33. For 1986, Duo's labor rate variance would be
  a. $40,000 unfavorable.
  b. $32,000 favorable.
  c. $10,000 unfavorable.
  d. $0.

2N86#21. Tub Co. uses a standard cost system. The following information pertains to direct labor for product B for the month of October:

Actual rate paid $8.40 per hour
Standard rate $8.00 per hour
Standard hours allowed for actual production 2,000 hours
Labor efficiency variance $1,600 unfavorable

What were the actual hours worked?
  a. 1,800
  b. 1,810
  c. 2,190
  d. 2,200

2N86#28. 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:

Sales $200,000
Beginning inventory 50,000
Purchases 130,000

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

2N86#35. 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%

2N86#36. 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>
<tr>
<td></td>
<td>12</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)

2N86#40. 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

AP-96
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 1

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
- b. $120,000
- c. $200,000
- d. $276,000

2M86#40. Gata Co. plans to discontinue a department with a $48,000 contribution to overhead, and allocated overhead of $96,000, of which $42,000 cannot be eliminated. What would be the effect of this discontinuance on Gata's pretax profit?
- a. Increase of $48,000.
- b. Decrease of $48,000.
- c. Increase of $6,000.
- d. Decrease of $6,000.

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.

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
- b. $130
- 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
- b. 1,600
- 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
- b. $100,000
- c. $ 24,000
- d. $ 4,000

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>

AP-97
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 main-
tenance costs (Y) as a function of machine hours (X):

\[ Y = 12,000 + 10.50 \times X. \]

VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting

2M68

Items 44 through 50 are based on the following infor-
mation:

Maple Township uses encumbrance accounting, and
formally integrates its budget into the accounting
records for its general fund. For the year ending June
30, 1988, the Township Council adopted a budget com-
prising estimated revenues of $10,000,000, appropri-
tions of $9,000,000, and an estimated transfer of
$300,000 to the debt service fund. The following ad-
ditional information is provided:

- For the month of April 1988, salaries and wages
  expense of $200,000 was incurred.
- On April 10, 1988, an approved $1,500 purchase
  order was issued for supplies. These supplies were
  received on May 1, 1988, and the $1,500 invoice was
  approved for payment.
- In November 1987, an unexpected state grant of
  $100,000 was received to finance the purchase of
  school buses, and an additional grant of $5,000 was
  received for bus maintenance and operations. Only
  $60,000 of the capital grant was used in the current
  year for the purchase of buses, but the entire op-
  erating grant of $5,000 was disbursed in the current
  year. The remaining $40,000 of the capital grant is
  expected to be expended during the year ending
  June 30, 1989. Maple's school bus system is appro-
  priately accounted for in the capital projects fund.

44. On adoption of the budget, the journal entry to
record the budgetary fund balance should include a
a. Debit of $700,000.
b. Credit of $700,000.
c. Debit of $1,000,000.
d. Credit of $1,000,000.

45. Budgeted revenues would be recorded by a
a. Debit to estimated revenues control, $10,000,000.

b. Debit to estimated revenues receivable, $10,000,000.
c. Credit to estimated revenues, $10,000,000.
d. Credit to other financing sources control, $10,000,000.

46. Budgeted appropriations would be recorded by a
a. Debit to estimated expenditures, $9,300,000.
b. Credit to appropriations control, $9,300,000.
c. Debit to estimated expenditures, $9,000,000.
d. Credit to appropriations control, $9,000,000.

47. What journal entry should be made on April 10,
1988, to record the approved purchase order?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditures</td>
<td></td>
</tr>
<tr>
<td>Encumbrances</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Encumbrances</td>
<td></td>
</tr>
<tr>
<td>Expenditures</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Encumbrances</td>
<td></td>
</tr>
<tr>
<td>Fund balance</td>
<td></td>
</tr>
<tr>
<td>for encumbrances</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Encumbrances</td>
<td></td>
</tr>
<tr>
<td>Appropriations control</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
</tbody>
</table>

48. What journal entries should be made on May 1,
1988, upon receipt of the supplies and approval of the
invoice?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Encumbrances</td>
<td></td>
</tr>
<tr>
<td>Appropriations control</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Supplies expense</td>
<td></td>
</tr>
<tr>
<td>Vouchers payable</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Encumbrances</td>
<td></td>
</tr>
<tr>
<td>Fund balance</td>
<td></td>
</tr>
<tr>
<td>for encumbrances</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Expenditures control</td>
<td></td>
</tr>
<tr>
<td>Vouchers payable</td>
<td></td>
</tr>
<tr>
<td>$1,500</td>
<td>$1,500</td>
</tr>
</tbody>
</table>
Selected Questions

49. In connection with the grants for the purchase of school buses and bus maintenance and operations, what amount should be reported as grant revenues for the year ending June 30, 1988?
   a. $5,000
   b. $60,000
   c. $65,000
   d. $100,000

50. What journal entry should be made to record the salaries and wages expense incurred for April?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and wages expense</td>
<td>$200,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>$200,000</td>
</tr>
<tr>
<td>Appropriations control</td>
<td>200,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>200,000</td>
</tr>
<tr>
<td>Encumbrances control</td>
<td>200,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>200,000</td>
</tr>
<tr>
<td>Expenditures control</td>
<td>200,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>200,000</td>
</tr>
</tbody>
</table>

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?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Memorandum entry only</td>
</tr>
<tr>
<td>b.</td>
<td>Encumbrances control</td>
</tr>
<tr>
<td></td>
<td>Fund balance reserved for encumbrances</td>
</tr>
<tr>
<td>c.</td>
<td>Supplies</td>
</tr>
<tr>
<td></td>
<td>Vouchers payable</td>
</tr>
<tr>
<td>d.</td>
<td>Encumbrances control</td>
</tr>
<tr>
<td></td>
<td>Appropriations control</td>
</tr>
</tbody>
</table>

60. What journal entry or entries should Albee make on May 2, 1984, upon receipt of the supplies and approval of the invoice?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Appropriations control</td>
</tr>
<tr>
<td></td>
<td>Encumbrances control</td>
</tr>
<tr>
<td></td>
<td>Supplies</td>
</tr>
<tr>
<td></td>
<td>Vouchers payable</td>
</tr>
<tr>
<td>b.</td>
<td>Supplies</td>
</tr>
<tr>
<td></td>
<td>Vouchers payable</td>
</tr>
<tr>
<td>c.</td>
<td>Fund balance reserved for encumbrances</td>
</tr>
<tr>
<td></td>
<td>Encumbrances control</td>
</tr>
<tr>
<td></td>
<td>Expenditures control</td>
</tr>
<tr>
<td></td>
<td>Vouchers payable</td>
</tr>
<tr>
<td>d.</td>
<td>Encumbrances control</td>
</tr>
<tr>
<td></td>
<td>Appropriations control</td>
</tr>
<tr>
<td></td>
<td>Fund balance</td>
</tr>
<tr>
<td></td>
<td>Vouchers payable</td>
</tr>
</tbody>
</table>
B. Types of Funds and Fund Accounts

2M88#41. The following items were among Wood Township's expenditures from the general fund during the year ended June 30, 1987:

- Furniture for Township Hall $10,000
- Minicomputer for tax collector's office 15,000

The amount that should be classified as fixed assets in Wood's general fund balance sheet at June 30, 1987 is
a. $25,000
b. $15,000
c. $10,000
d. $0

2M88#42. During 1987, Pine City recorded the following receipts from self-sustaining activities paid for by users of the services rendered:

- Municipal bus system $1,000,000
- Operation of water supply and sewerage plant 1,800,000

What amount should be accounted for in Pine's enterprise funds?
- $2,800,000
- $1,800,000
- $1,000,000
- $0

2M88#43. Grove County collects property taxes levied within its boundaries and receives a 1% fee for administering these collections on behalf of the municipalities located in the county. In 1987, Grove collected $1,000,000 for its municipalities and remitted $990,000 to them after deducting fees of $10,000. In the initial recording of the 1% fee, Grove's agency fund should credit
- Fund balance — agency fund, $10,000.
- Fees earned — agency fund, $10,000.
- Due to Grove County general fund, $10,000.
- Revenues control, $10,000.

2M87#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
- $5,000,000 in 1986.
- $3,000,000 in 1987.
- $1,000,000 in 1986 and $4,000,000 in 1987.
- $1,000,000 in 1986 and in the general fund for $4,000,000 in 1986.

2M87#52. The following proceeds were received by Kew City from specific revenue sources that are legally restricted to expenditure for specified purposes:

- Gasoline taxes to finance road repairs $400,000
- Levies on affected property owners to finance sidewalk repairs 300,000

The amount that should be accounted for in Kew's special revenue funds is
- $0
- $300,000
- $400,000
- $700,000

2M87#53. Wells Township issued the following long-term obligations:

- Revenue bonds to be repaid from admission fees collected by the township swimming pool $500,000
- General obligation bonds issued for the township water and sewer fund which will service the debt 900,000

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?
- $1,400,000
- $900,000
- $500,000
- $0

2M87#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?
Selected Questions

2N87#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>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Special assessments receivable — current</td>
<td>$60,000</td>
</tr>
<tr>
<td>— deferred</td>
<td>240,000</td>
</tr>
<tr>
<td>b. Special assessments receivable — current</td>
<td>$60,000</td>
</tr>
<tr>
<td>— deferred</td>
<td>240,000</td>
</tr>
<tr>
<td>c. Special assessments receivable $300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>— deferred</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

2N87#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>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Machinery and equipment Investment in general fixed assets from private gifts</td>
<td>$200,000</td>
</tr>
<tr>
<td>b. Investment in general fixed assets</td>
<td>$200,000</td>
</tr>
<tr>
<td>Gift revenue</td>
<td>$200,000</td>
</tr>
<tr>
<td>c. General fund assets</td>
<td>$200,000</td>
</tr>
<tr>
<td>Private gifts</td>
<td>$200,000</td>
</tr>
<tr>
<td>d. Memorandum entry only</td>
<td>—</td>
</tr>
</tbody>
</table>

Sales price $12,000
Cost 14,000
Carrying amount 10,000

Nous made the correct entry to record the $2,000 gain on sale.

58. The amount that should be debited and credited for the additional entry in connection with this sale is

a. $2,000
b. $10,000
c. $12,000
d. $14,000

2M64
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

2M64#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 of 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

2M64
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 benefited

$300,000

For construction of public swimming pool; bonds to be paid from pledged fees collected from pool users

400,000

How much should be accounted for through debt service funds for payments of principal over the life of the bonds?
   a. $0
   b. $300,000
   c. $400,000
   d. $700,000

D. Various Types of Not-for-Profit and Governmental Organizations

2M88#51. On March 1, 1988, Allan Rowe established a $100,000 endowment fund, the income from which is to be paid to Elm Hospital for general operating purposes. Elm does not control the fund's principal. Rowe appointed West National Bank as trustee of this fund.

What journal entry is required by Elm to record the establishment of the endowment?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Nonexpendable endowment fund</td>
<td>$100,000</td>
</tr>
<tr>
<td>Cash Endowment fund balance</td>
<td>100,000</td>
</tr>
<tr>
<td>Nonexpendable endowment fund Endowment fund balance</td>
<td>100,000</td>
</tr>
<tr>
<td>Memorandum entry only</td>
<td>—</td>
</tr>
</tbody>
</table>

2M88#52. In 1988, Wells Hospital received an unrestricted bequest of common stock with a fair market value of $50,000 on the date of receipt of the stock. The testator had paid $20,000 for this stock in 1986. Wells should record this bequest as
   a. Nonoperating revenue of $50,000.
   b. Nonoperating revenue of $30,000.
   c. Nonoperating revenue of $20,000.
   d. A memorandum entry only.

2M88#53. Cedar Hospital has a marketable equity securities portfolio that is appropriately included in noncurrent assets in unrestricted funds. The portfolio has an aggregate cost of $300,000. It had an aggregate fair market value of $250,000 at the end of 1987 and $290,000 at the end of 1986. If the portfolio was properly reported in the balance sheet at the end of 1986, the change in the valuation allowance at the end of 1987 should be
   a. $0.
   b. A decrease of $40,000.
   c. An increase of $40,000.
   d. An increase of $50,000.

2M88#54. Ross Hospital's accounting records disclosed the following information:

- Net resources invested in plant assets $10,000,000
- Board-designated funds 2,000,000

What amount should be included as part of unrestricted funds?
   a. $12,000,000
   b. $10,000,000
   c. $ 2,000,000
   d. $0

2M88#55. In April 1987, Alice Reed donated $100,000 cash to her church, with the stipulation that the income generated from this gift is to be paid to
Selected Questions

Alice during her lifetime. The conditions of this donation are that, after Alice dies, the principal can be used by the church for any purpose voted on by the church elders. The church received interest of $8,000 on the $100,000 for the year ended March 31, 1988, and the interest was remitted to Alice. In the church’s March 31, 1988 financial statements

a. $8,000 should be reported under support and revenue in the activity statement.
b. $92,000 should be reported under support and revenue in the activity statement.
c. $100,000 should be reported as deferred support in the balance sheet.
d. The gift and its terms should be disclosed only in notes to the financial statements.

2M88#56. The following expenditures were among those incurred by a nonprofit botanical society during 1987:

Printing of annual report $10,000
Unsolicited merchandise sent to encourage contributions 20,000

What amount should be classified as fund-raising costs in the society’s activity statement?

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

2M88#57. Unity Fund is a voluntary welfare organization funded by contributions from the general public. During 1987, unrestricted pledges of $100,000 were received, half of which were payable in 1987, with the other half payable in 1988 for use in 1988. It was estimated that 20% of these pledges would be uncollectible. With respect to the pledges, the amount that should be reported for 1987 as net contributions, under public support, is

a. $100,000
b. $80,000
c. $50,000
d. $40,000

2M88#58. For the 1987 summer session, Selva University assessed its students $300,000 for tuition and fees. However, the net amount realized was only $290,000 because of the following reductions:

Tuition remissions granted to faculty members’ families $3,000
Class cancellation refunds 7,000

How much unrestricted current funds revenues from tuition and fees should Selva report for the period?

a. $290,000
b. $293,000
c. $297,000
d. $300,000

2M88#59. The following information was available from Forest College’s accounting records for its current funds for the year ended March 31, 1988:

<table>
<thead>
<tr>
<th>Restricted gifts received</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expended</td>
<td></td>
</tr>
<tr>
<td>Not expended</td>
<td>300,000</td>
</tr>
<tr>
<td>Unrestricted gifts received</td>
<td></td>
</tr>
<tr>
<td>Expended</td>
<td>600,000</td>
</tr>
<tr>
<td>Not expended</td>
<td>75,000</td>
</tr>
</tbody>
</table>

What amount should be included in current funds revenues for the year ended March 31, 1988?

a. $600,000
b. $700,000
c. $775,000
d. $1,000,000

2M88#60. The following expenditures were among those incurred by Alma University during 1987:

Administrative data processing $50,000
Scholarships and fellowships 100,000
Operation and maintenance of physical plant 200,000

The amount to be included in the functional classification “Institutional Support” expenditures account is

a. $50,000
b. $150,000
c. $250,000
d. $350,000

2N87#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

2N87#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

2N87#43. Park College is sponsored by a religious group. Volunteers from this religious group regularly contribute their services to Park, and are paid nominal
Accounting Practice

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. $500,000
c. $312,000
d. $0

2N87#44. Abbey University’s unrestricted current funds comprised the following:

<table>
<thead>
<tr>
<th>Assets</th>
<th>$5,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities (including</td>
<td></td>
</tr>
<tr>
<td>deferred revenues of</td>
<td></td>
</tr>
<tr>
<td>$100,000)</td>
<td></td>
</tr>
</tbody>
</table>

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

2N87#45. The following receipts were among those recorded by Kery College during 1986:

<table>
<thead>
<tr>
<th>Unrestricted gifts</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restricted current funds</td>
<td></td>
</tr>
<tr>
<td>(expended for current operating</td>
<td>200,000</td>
</tr>
<tr>
<td>purposes)</td>
<td></td>
</tr>
<tr>
<td>Restricted current funds</td>
<td></td>
</tr>
<tr>
<td>(not yet expended)</td>
<td>100,000</td>
</tr>
</tbody>
</table>

The amount that should be included in current funds revenues is

a. $800,000
b. $700,000
c. $500,000
d. $500,000

2N87#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

2N87#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

2N87#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.

2N87#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. $550,000

2N87
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:

| Sales price | $12,000 |
| Cost        | 14,000  |
| Carrying amount | 10,000 |

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>Fund balance — expended</td>
<td>Fund balance — unexpended</td>
</tr>
<tr>
<td>Fund balance — unexpended</td>
<td>Fund balance — expended</td>
</tr>
<tr>
<td>Sale of equipment</td>
<td>Fund balance — undesignated</td>
</tr>
<tr>
<td>Current unrestricted funds</td>
<td></td>
</tr>
</tbody>
</table>
**Selected Questions**

2N87#59. The following funds are among those maintained by Arlon City:

<table>
<thead>
<tr>
<th>Fund Type</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

a. $0
b. $ 800,000
c. $2,000,000
d. $2,800,000

2N87#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.

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 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 Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund-raising</td>
<td>$500,000</td>
</tr>
<tr>
<td>Administrative</td>
<td></td>
</tr>
<tr>
<td>(including data processing)</td>
<td>$300,000</td>
</tr>
<tr>
<td>Research</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Cura’s functional expenses for 1983 program services included

a. $900,000
b. $500,000
c. $300,000
d. $100,000

2M84#55. The following funds were among those on Kery University’s books at April 30, 1984:

<table>
<thead>
<tr>
<th>Cost Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds to be used for acquisition of additional properties for University purposes (unexpended at 4/30/84)</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Funds set aside for debt service charges and for retirement of indebtedness on University properties</td>
<td>5,000,000</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
Accounting Practice

IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income

2M88#1. John Budd is single, with no dependents. During 1987, John received wages of $11,000 and state unemployment compensation benefits of $2,000. He had no other source of income. The amount of state unemployment compensation benefits that should be included in John’s 1987 adjusted gross income is
   a. $2,000
   b. $1,000
   c. $ 500
   d. $0

2M88#2. In 1987, Emil Gow won $5,000 in a state lottery. Also in 1987, Emil spent $400 for the purchase of lottery tickets. Emil elected the standard deduction on his 1987 income tax return. The amount of lottery winnings that should be included in Emil’s 1987 taxable income is
   a. $0
   b. $2,000
   c. $4,600
   d. $5,000

2M88#3. In 1970, Betty Lane bought 100 shares of a listed corporation’s stock for $8,000. In 1987, Betty sold this stock for $15,000. Betty had no other capital gains or losses in 1987. How much of the 1987 long-term capital gain should be included in Betty’s 1987 taxable income?
   a. $2,800
   b. $3,500
   c. $4,200
   d. $7,000

2M88#4. For a married couple filing a 1987 joint return, the excess of net long-term capital loss over net short-term capital gain is
   a. Reduced by 50% before being deducted from ordinary income.
   b. Limited to a maximum deduction of $3,000 from ordinary income.
   c. Allowed as a carryover against future capital gains up to a maximum period of five years.
   d. Not deductible from ordinary income.

2M88#5. Al and Iris Oran, who are married, received $10,000 in 1987 as dividends from taxable domestic corporations. In the Orans’ 1987 joint return, the amount of these dividends subject to tax is
   a. $10,000
   b. $ 9,900
   c. $ 9,800
   d. $ 8,500

2M88#6. During 1987, Ruth Loy received interest income as follows:
   a. $3,000
   b. $ 200
   c. $3,200
   d. $0

The total amount of interest subject to tax in Ruth’s 1987 return is

2M88#9. Gary Judd is an individual proprietor trading as Lake Stores, an accrual basis enterprise that had been using the reserve method for determining bad debt expense for both book and tax purposes. At December 31, 1986, Lake’s allowance for doubtful accounts (“bad debt reserve”) was $20,000. In Lake’s 1987 budget, it was estimated that $3,000 of trade accounts receivable would become worthless in 1987. However, actual bad debts amounted to $4,000 in 1987. In Lake’s 1987 Schedule C of Form 1040, Lake is allowed
   a. A $4,000 deduction for bad debts, but must also include $5,000 of the “reserve” in taxable income.
   b. A $4,000 deduction for bad debts, and does not have to include any portion of the “reserve” in taxable income.
   c. No deduction for bad debts since these bad debts should be charged against the “reserve.”
   d. A $1,000 deduction for bad debts, which is the excess of actual bad debts over the amount estimated.

2N87#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

2N87#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
Selected Questions

2N87#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

2N87#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.

2N87#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.

2N87#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

2N87#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

2N87#9. In 1987, Gail Judd received the following dividends from

<table>
<thead>
<tr>
<th>Benefit Life Insurance Co., on Gail's life insurance policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>($)</td>
</tr>
<tr>
<td>$100</td>
</tr>
<tr>
<td>Safe National Bank, on bank's common stock</td>
</tr>
<tr>
<td>300</td>
</tr>
<tr>
<td>Roe Mfg. Corp., a Delaware corporation, on preferred stock</td>
</tr>
<tr>
<td>500</td>
</tr>
</tbody>
</table>

What amount of dividend income should Gail report

a. $900  
b. $800  
c. $500  
d. $300

2N87#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

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 investment)</td>
<td>800</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

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

2M85#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

2M85#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:

21. How much should Ana include in her 1984 taxable income as alimony?
   a. $0
   b. $2,100
   c. $25,000
   d. $27,100

2M85 Items 23 and 24 are based on the following data:

   Ray Birch, age 60, is single with no dependents. Birch's only income is from his occupation as a self-employed plumber. Birch owns the following assets used in his plumbing business:

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land on which a storage shack is erected</td>
<td>$3,000</td>
</tr>
<tr>
<td>Shack for storage of plumbing supplies</td>
<td>12,000</td>
</tr>
</tbody>
</table>

23. Birch must file a return for 1985 if his net earnings from self-employment are at least
   a. $400
   b. $1,000
   c. $2,300
   d. $3,300

24. The capital assets used by Birch in his business amount to
   a. $0
   b. $3,000
   c. $12,000
   d. $15,000

2M85 Items 25 through 29 are based on the following data:

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy's mother, Cora, age 85, who earned $800 from baby sitting jobs and received $1,900 in social security benefits during 1984. Cora lives alone in her own apartment.

Emil earned a salary of $60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer's pension plan. Judy, who worked part-time
in 1984 and earned $1,000, is not covered by an employer's pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts from business</td>
<td>$120,000</td>
</tr>
<tr>
<td>Dividend income from personal investments</td>
<td>800</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>60,000</td>
</tr>
<tr>
<td>Other business operating expenses</td>
<td>12,000</td>
</tr>
<tr>
<td>State business taxes</td>
<td>1,200</td>
</tr>
<tr>
<td>Federal self-employment tax</td>
<td>4,271</td>
</tr>
</tbody>
</table>

For the year ended December 31, 1984, how much should Krug report as net earnings from self-employment?

   a. $42,529  
   b. $46,800  
   c. $47,600  
   d. $48,000

2M85#32. The following information pertains to the acquisition of a six-wheel truck by Sol Barr, a self-employed contractor:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of original truck traded in</td>
<td>$20,000</td>
</tr>
<tr>
<td>Book value of original truck at</td>
<td>4,000</td>
</tr>
<tr>
<td>trade-in date</td>
<td>4,000</td>
</tr>
<tr>
<td>List price of new truck</td>
<td>25,000</td>
</tr>
<tr>
<td>Trade-in allowance for old truck</td>
<td>6,000</td>
</tr>
<tr>
<td>Business use of both trucks</td>
<td>100%</td>
</tr>
</tbody>
</table>

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

2M85#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</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
Selected Questions

$500 a month. Boss paid Carl $8,000 in 1983 to cover the following:

| Rent for January to December 1983 | $6,000 |
| Advance rent for January 1984 | 500 |
| Security deposit, to be applied against the final three months' rent in the fifth year of the lease | 1,500 |

Carl also received the following dividends in 1983, from:

- Mutual Life Insurance Co., on Carl's life insurance policy $300
- General Merchandise Corp., a Texas corporation, on preferred stock 400
- Second National Bank, on bank's common stock 800

On July 1, 1983, Carl sold for $9,500, on the open market, a $10,000 face value 10-year, noncallable, Doe Corp. bond. This bond was part of an original issue by Doe on July 1, 1981, and was purchased by Carl on that date, at a discount of $1,200, for a net price of $8,800.

30. How much should Carl report on his 1983 income tax return as compensation income received from Canova?
   a. $50,000  
   b. $51,000  
   c. $52,000  
   d. $53,000

31. How much rent income should Carl report in his 1983 income tax return for the amounts paid to him by Boss?
   a. $6,000  
   b. $6,500  
   c. $7,500  
   d. $8,000

32. Before the dividend exclusion, how much dividend income should Carl report in his 1983 income tax return?
   a. $400  
   b. $1,100  
   c. $1,200  
   d. $1,500

33. What is Carl's long-term capital gain in 1983, on the sale of the Doe bond?
   a. $0  
   b. $460  
   c. $700  
   d. $1,200

2MB4#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

2MB4 Items 22 through 28 are based on the following data:

Laura Lewis has been legally separated from her husband, Herman, since 1982. Their three-year old son, Ronald, lived with Laura for the entire year 1983. Under the written separation agreement between Laura and Herman, Herman was obligated to pay Laura $300 per month for alimony and $200 per month for child support, or a total of $6,000 annually. However, Laura received a total of only $300 from Herman during 1983. Laura's other income in 1983 was from the following sources:

- Salary $20,000
- Interest on insurance dividends left on deposit with a life insurance company 100
- Interest on federal income tax refund 60

In addition, Laura's father, Albert, gave Laura a gift of 500 shares of Liba Corporation common stock in 1983. Albert's basis for the Liba stock was $4,000. At the date of this gift, the fair market value of the Liba stock was $3,000.

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

25. 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

AP-111
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. Upon John's death, 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

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

2M88#15. Paul and Lois Lee, both age 50, are married and filed a joint return for 1987. Their 1987 adjusted gross income was $80,000, including Paul's $75,000 salary. Lois had no income of her own. Neither spouse was covered by an employer-sponsored pension plan. What amount could the Lees contribute to IRAs for 1987 to take advantage of their maximum allowable IRA deduction in their 1987 return?
   a. $0
   b. $2,000
   c. $2,250
   d. $4,000

2M88#16. Eric Kay, age 59, is single and has no dependents. In 1988, Eric sold his personal residence for the net amount of $300,000 after all selling expenses. He bought the house in 1960 and occupied it until sold. The house had a basis of $100,000 on the date of sale. Eric moved into a rental apartment and does not intend to buy another residence. What is the maximum portion of the gain on sale of the residence that Eric may exclude from his 1988 taxable income?
   a. $0
   b. $62,500
   c. $125,000
   d. $200,000

2N87#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.

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:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Travel</td>
<td>$10,000</td>
</tr>
<tr>
<td>Secretarial</td>
<td>7,000</td>
</tr>
<tr>
<td>Telephone</td>
<td>1,000</td>
</tr>
</tbody>
</table>

How should these expenses be deducted in Joel's 1985 return?

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 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

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 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

26. The Ryans do not itemize their deductions. How much can they contribute to IRAs in order to take advantage of their maximum allowable deduction for IRAs in their 1984 return?
   a. $0
   b. $1,000
   c. $2,250
   d. $3,000

2M84#21. Earl Cook, who worked as a machinist for Precision Corp., loaned Precision $1,000 in 1980. Cook did not own any of Precision's stock, and the loan was not a condition of Cook's employment by Precision. In 1984, Precision declared bankruptcy, and Cook's note receivable from Precision became worthless. What loss can Cook claim on his 1984 income tax return?
   a. $0
   b. $500 long-term capital loss.
   c. $1,000 short-term capital loss.
   d. $1,000 business bad debt.

2M84  
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  
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
Accounting Practice

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

C. Gain or Loss on Property Transactions

2M87
Items 18 through 20 are based on the following data:

In 1980, Iris King bought a diamond necklace for her own use, at a cost of $10,000. In 1987, when the fair market value was $12,000, Iris gave this necklace to her daughter, Ruth. No gift tax was due.

18. Ruth’s holding period for this gift
   c. Depends on whether the necklace is sold by Ruth at a gain or at a loss.
   d. Is irrelevant because Ruth received the necklace for no consideration of money or money’s worth.

19. This diamond necklace is a
   a. Capital asset.
   b. Section 1231 asset.
   c. Section 1245 asset.
   d. Section 1250 asset.

20. If Ruth sells this diamond necklace in 1988 for $13,000, Ruth’s recognized gain would be
   a. $3,000
   b. $2,000
   c. $1,000
   d. $0

2M86#44. At December 31, 1985, the following assets were among those owned by Eli York:

<table>
<thead>
<tr>
<th>Date acquired</th>
<th>A</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>a. $300</td>
<td>$0</td>
</tr>
<tr>
<td>b. $225</td>
<td>$75</td>
</tr>
<tr>
<td>c. $200</td>
<td>$100</td>
</tr>
<tr>
<td>d. $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
40. 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.

2M84
Items 34 through 36 are based on the following data:

On March 1, 1983, Lois Rice learned that she was bequeathed 1,000 shares of Elin Corp. common stock under the will of her uncle, Pat Prevor. Pat had paid $5,000 for the Elin stock in 1980. Fair market value of the Elin stock on March 1, 1983, the date of Pat’s death, was $8,000 and had increased to $11,000 six months later. The executor of Pat’s estate elected the alternative valuation date for estate tax purposes. Lois sold the Elin stock for $9,000 on May 1, 1983, the date that the executor distributed the stock to her.

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. 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 $250,000. How much gain should Herr recognize in his 1984 income tax return?
   a. $0
   b. $ 80,000
   c. $150,000
   d. $330,000

D. Deductions From Adjusted Gross Income

2M88#7. The unreimbursed 1987 employee travel expenses of an outside salesperson are
   a. Fully deductible from gross income in arriving at adjusted gross income.
   b. Deductible only as miscellaneous itemized deductions subject to a 2% floor.
   c. Fully deductible only as miscellaneous itemized deductions.
   d. Not deductible.

2M88#12. If both a husband and wife are wage earners and file a 1987 joint return, a two-earner wage deduction may be claimed
   a. As an exclusion in arriving at adjusted gross income.
   b. As a special deduction from adjusted gross income.
   c. As a miscellaneous itemized deduction subject to a 2% floor.
   d. Under no circumstances.

2M88#13. The unreimbursed moving expenses of an employee who takes a new job 100 miles away from a previous residence and place of employment are
   a. Fully deductible from gross income in arriving at adjusted gross income.
   b. Deductible only as miscellaneous itemized deductions subject to a 2% floor.
   c. Fully deductible only as miscellaneous itemized deductions.
   d. Not deductible.

2M88#14. Alan Curtis, who is single, had an adjusted gross income of $40,000 in 1987, and he used the standard deduction in his 1987 return. During 1987, Alan contributed $300 to the building fund of State University. What amount was deductible for contributions in Alan’s 1987 return?
   a. $0
   b. $ 50
   c. $100
   d. $300

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>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on note payable to a bank; proceeds of loan were used to buy municipal bonds</td>
<td>$1,000</td>
</tr>
<tr>
<td>Payments pertaining to condominium apartment occupied by Burt: Interest ($3,000) and principal ($2,200) on mortgage</td>
<td>$5,200</td>
</tr>
<tr>
<td>Realty taxes</td>
<td>$1,800</td>
</tr>
<tr>
<td>State and city gasoline taxes</td>
<td>$150</td>
</tr>
<tr>
<td>State hunting license fee</td>
<td>$25</td>
</tr>
<tr>
<td>Legal fee for preparation of will</td>
<td>$100</td>
</tr>
<tr>
<td>Education expenses to qualify for new occupation</td>
<td>$975</td>
</tr>
</tbody>
</table>

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. $ 975
c. $ 100
d. $0

Items 38 and 39 are based on the following data:

Gene Blake, who is single, had an adjusted gross income of $50,000 in 1984. During 1984 Gene paid the following unreimbursed medical and dental expenses:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical insurance premiums</td>
<td>$300</td>
</tr>
<tr>
<td>Dental surgery</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Also in 1984, Gene suffered a $4,000 loss due to vandalism, for which Gene had no insurance. Gene itemized his deductions for 1984.

38. How much was deductible in Gene’s 1984 return for medical and dental expenses?

a. $150
b. $ 300
c. $2,800
d. $3,800

39. How much was deductible in Gene’s 1984 return as a casualty loss?

a. $0
b. $ 100
c. $3,900
d. $4,000
Selected Questions

2M85

Items 33 through 36 are based on the following data:

Bart Sheen, who is single, itemizes his deductions. The following were among Bart’s cash expenditures during 1984:

Interest on bank loan to purchase taxable securities $1,000
Finance charges on a revolving charge account at a department store, based on monthly unpaid balances 400
Fourth quarter 1983 estimated state income tax 1,200
City real estate taxes on property owned by Bart and leased to a tenant 3,000
Charitable contributions 5,000
Contribution to candidate for public office 200

34. How much interest expense should Bart include in his schedule of itemized deductions for 1984?
   a. $0
   b. $ 400
   c. $1,000
   d. $1,400

35. How much should Bart include as taxes in his schedule of itemized deductions for 1984?
   a. $0
   b. $1,200
   c. $3,000
   d. $4,200

2N84

Items 22 through 26 are based on the following data:

Eric Ross, who is single and has no dependents, had an adjusted gross income of $80,000 in 1983, comprised of the following:

Salary $74,000
Net investment income 6,000

During 1983, uninsured art objects owned by Eric, with a basis of $50,000 and a fair market value of $70,000, sustained casualty fire damage reducing the fair market value 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.

22. How much can Eric claim in his itemized deductions for interest on his 1983 return?
   a. $ 6,000
   b. $12,000
   c. $16,000
   d. $18,000

23. How much can Eric claim as taxes in itemized deductions on his 1983 return?
   a. $0
   b. $ 180
   c. $3,000
   d. $3,180

24. How much can Eric claim in his itemized deductions for medical and dental expenses on his 1983 return?
   a. $2,400
   b. $ 800
   c. $ 300
   d. $ 150

25. How much can Eric claim in his itemized deductions for the casualty loss on his 1983 return?
   a. $0
   b. $1,900
   c. $2,000
   d. $9,900

2N84#28. Dan Barlow, who itemizes his deductions, had an adjusted gross income of $70,000 in 1983. The following additional information is available for 1983:

Cash contribution to church $5,000
Purchase of art object at church bazaar (with a fair market value of $1,000 on the date of purchase) 1,600
Donation of used clothing to Salvation Army (fair value evidenced by receipt received) 800

What is the maximum amount Barlow can claim as a deduction for charitable contributions in 1983?
   a. $5,600
   b. $6,400
   c. $6,600
   d. $6,800

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
Accounting Practice

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 30.
Contribution to an individual retirement account ($200 interest was earned on this IRA in 1983) 2,000 31.
Dental expenses 700 33.
Premium on Roger's life insurance policy 600 32.
Medical insurance premiums 500 32.
Contribution to candidate for public office 300 32.
Legal fee for preparation of Roger's will 200 32.
Customs duties 80 32.
City dog license fee 10 32.

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

E. Filing Status and Exemptions

2M87#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.

2M88#44. 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

2M90#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 Single.
   b. Married filing joint return.
   c. Head of household.
   d. Qualifying widow with dependent child.

2M90#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.

2M89

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>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life insurance proceeds on the death of an unrelated friend</td>
<td>$8,000</td>
</tr>
<tr>
<td>Interest on income tax refund</td>
<td>100</td>
</tr>
<tr>
<td>Interest on life insurance policy's accumulated dividends</td>
<td>300</td>
</tr>
<tr>
<td>Dividends on stock of a Swiss corporation</td>
<td>500</td>
</tr>
<tr>
<td>Dividend on life insurance policy</td>
<td>200</td>
</tr>
</tbody>
</table>

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>Supporter</th>
<th>Amount</th>
<th>Percent of total</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

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.

Selected Questions

Salary $20,000  
Interest on insurance dividends  
left on deposit with a life insurance company $100  
Interest on federal income tax refund $60

In addition, Laura's father, Albert, gave Laura a gift of 500 shares of Liba Corporation common stock in 1983. Albert's basis for the Liba stock was $4,000. At the date of this gift, the fair market value of the Liba stock was $3,000.

2M84

Items 36 through 40 are based on the following data:

John Budd, who was 58 at the date of his death on July 1, 1983, received $1,000 interest in 1983 on municipal bonds. John's wife, Emma, age 57, received a $300 television set in 1983 as a gift for opening a long-term savings account at a bank. Upon John's death, Emma received life insurance proceeds of $60,000 under a group policy paid for by John's employer. In addition, an employee death benefit of $7,500 was paid to Emma by John's employer. A month before John died, John and Emma sold their house for $225,000. They had lived in this house since 1970 and held the property as tenants by the entirety. Their basis for this property was $100,000. No replacement property was purchased and Emma does not intend to buy another residence. Emma did not remarry in 1983. Emma is executrix of John's estate.

36. With regard to John's and Emma's filing status for 1983, Emma should file
   a. As a single individual, and a separate return should be filed for John as unmarried head of household.  
   b. As a qualifying widow, and a separate return should be filed for John as married head of household.  
   c. As a qualifying widow, and a separate return should be filed for John as a single deceased individual.  
   d. A joint return including John, as married taxpayers.

F. Tax Computations and Credits

2M88#8. The maximum allowable credit for political contributions on a 1987 joint return is
   a. $100  
   b. $ 50  
   c. $ 25  
   d. $ 0
2M88#10. An employee who has had social security tax withheld in an amount greater than the maximum for a particular year, may claim
   a. The excess as a credit against income tax, if that excess was withheld by one employer.
   b. The excess as a credit against income tax, if that excess resulted from correct withholding by two or more employers.
   c. Reimbursement of such excess from his employers if that excess resulted from correct withholding by two or more employers.
   d. Such excess as either a credit or an itemized deduction, at the election of the employee, if that excess resulted from correct withholding by two or more employers.

2M86#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.

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$74,000</td>
</tr>
<tr>
<td>Net investment income</td>
<td></td>
</tr>
<tr>
<td>Interest on margin account at stockbroker</td>
<td>$18,000</td>
</tr>
<tr>
<td>Real estate taxes on condominium owned by Eric's mother, in which Eric resides</td>
<td>$3,000</td>
</tr>
<tr>
<td>State and city gasoline taxes</td>
<td>$180</td>
</tr>
<tr>
<td>Medical insurance premiums</td>
<td>$300</td>
</tr>
<tr>
<td>Unreimbursed dental expenses</td>
<td>$4,500</td>
</tr>
<tr>
<td>Contribution to political committee of elected public official</td>
<td>$500</td>
</tr>
</tbody>
</table>

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

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on bank loan to purchase taxable securities</td>
<td>$1,000</td>
</tr>
<tr>
<td>Finance charges on a revolving charge account</td>
<td>400</td>
</tr>
<tr>
<td>Fourth quarter 1983 estimated state income tax income tax</td>
<td>1,200</td>
</tr>
<tr>
<td>City real estate taxes on property owned by Bart and leased to a tenant</td>
<td>3,000</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>5,000</td>
</tr>
<tr>
<td>Contribution to candidate for public office</td>
<td>200</td>
</tr>
</tbody>
</table>

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

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate taxes on Roger's condominium</td>
<td>$4,000</td>
</tr>
<tr>
<td>Contribution to an individual retirement account ($200 interest was earned on this IRA in 1983)</td>
<td>2,000</td>
</tr>
</tbody>
</table>
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

2N87#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 by the due date.
   c. 6 years from the date the return was filed, if filed before the due date.
   d. 6 years from the date the return was due, if filed by the due date.

2N87#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.

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

2N84#36. 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

2M88#17. All trusts, except tax exempt trusts,
   a. Must adopt a calendar year, except for existing trusts with fiscal years ended in 1987.
   b. May adopt a calendar year or any fiscal year.
   c. Must adopt a calendar year regardless of the year the trust was established.
   d. Must use the same taxable year as that of its principal beneficiary.

2M88#18. For income tax purposes, all estates
   a. Must adopt a calendar year, except for existing estates with fiscal years ended in 1987.
   b. May adopt a calendar year or any fiscal year.
   c. Must adopt a calendar year regardless of the year the estate was established.
   d. Must use the same taxable year as that of its principal beneficiary.

2M88#19. With regard to estimated income tax, estates
   a. Must make quarterly estimated tax payments starting no later than the second quarter following the one in which the estate was established.
   b. Are exempt from paying estimated tax during the estate's first two taxable years.
   c. Must make quarterly estimated tax payments only if the estate's income is required to be distributed currently.
   d. Are not required to make payments of estimated tax.

2M88#20. A complex trust is a trust that
   a. Must distribute income currently, but is prohibited from distributing principal during the taxable year.
   b. Invests only in corporate securities and is prohibited from engaging in short-term transactions.
   c. Permits accumulation of current income, provides for charitable contributions, or distributes principal during the taxable year.
   d. Is exempt from payment of income tax since the tax is paid by the beneficiaries.
2N87

Items 11 through 13 are based on the following data:

Alan Curtis, a U.S. citizen, died on March 1, 1987, leaving an adjusted gross estate with a fair market value of $1,400,000 at the date of death. Under the terms of Alan's will, $375,000 was bequeathed outright to his widow, free of all estate and inheritance taxes. The remainder of Alan's estate was left to his mother. Alan made no taxable gifts during his lifetime.

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

2N87#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.</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>No</td>
</tr>
</tbody>
</table>

2N88

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:

| At the date of Fred's death | $400,000 |
| Six months after Fred's death | 450,000 |
| Nine months after Fred's death | 480,000 |

Ida's basis for this stock is
   a. $380,000
   b. $400,000
   c. $450,000
   d. $480,000

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
Dividend on life insurance policy 200

27. How much of the life insurance proceeds should be reported by the Ryans in their 1984 return?
   a. $0
   b. $3,000
   c. $5,000
   d. $8,000

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

2M85

On March 1, 1984, Harry Beech received a gift of income-producing real estate having a donor’s adjusted basis of $50,000 at the date of the gift. Fair market value of the property at the date of the gift was $40,000. Beech sold the property for $46,000 on August 1, 1984. How much gain or loss should Beech report for 1984?
   a. No gain or loss.
   b. $6,000 short-term capital gain.
   c. $4,000 short-term capital loss.
   d. $4,000 ordinary loss.

2M84

Items 34 through 36 are based on the following data:

On March 1, 1983, Lois Rice learned that she was bequeathed 1,000 shares of Elin Corp. common stock under the will of her uncle, Pat Prevor. Pat had paid $5,000 for the Elin stock in 1980. Fair market value of the Elin stock on March 1, 1983, the date of Pat’s death, was $6,000 and had increased to $11,000 six months later. The executor of Pat’s estate elected the alternative valuation date for estate tax purposes. Lois sold the Elin stock for $9,000 on May 1, 1983, the date that the executor distributed the stock to her.

34. How much should Lois include in her 1983 individual income tax return for the inheritance of the 1,000 shares of Elin stock which she received from Pat’s estate?
   a. $0
   b. $5,000
   c. $8,000
   d. $11,000

2M84

Items 22 through 28 are based on the following data:

Laura Lewis has been legally separated from her husband, Herman, since 1982. Their three-year-old son, Ronald, lived with Laura for the entire year 1983. Under the written separation agreement between Laura and Herman, Herman was obligated to pay Laura $300 per month for alimony and $200 per month for child support, or a total of $6,000 annually. However, Laura received a total of only $300 from Herman during 1983. Laura’s other income in 1983 was from the following sources:

Salary $20,000
Interest on insurance dividends
   left on deposit with a life insurance company 100
Interest on federal income tax refund 60

In addition, Laura’s father, Albert, gave Laura a gift of 500 shares of Liba Corporation common stock in 1983. Albert’s basis for the Liba stock was $4,000. At the date of this gift, the fair market value of the Liba stock was $3,000.

25. How much was includible in Laura’s 1983 taxable income for the 500 shares of Liba stock?
   a. $0
   b. $3,000
   c. $3,500
   d. $4,000

26. If Laura sells the 500 shares of Liba stock in 1984 for $5,000, her basis is
   a. $5,000
   b. $4,000
   c. $3,000
   d. $0

27. If Laura sells the 500 shares of Liba stock in 1984 for $2,000, her basis is
   a. $4,000
   b. $3,000
   c. $2,000
   d. $0
A. Determination of Taxable Income or Loss

2M88#22. During 1987, Ral Corp. exchanged 5,000 shares of its own $10 par common stock for land with a fair market value of $75,000. As a result of this exchange, Ral should report in its 1987 tax return
   a. $25,000 Section 1245 gain.
   b. $25,000 Section 1231 gain.
   c. $25,000 ordinary income.
   d. No gain.

2M88#23. During 1987, Marb Corp. had net long-term capital losses of $7,000, net short-term capital gains of $3,000, gains of $1,500 on the sale of Section 1231 property, and losses of $2,000 on the sale of Section 1245 property. There was no capital loss carryforward from prior years. The capital gains deduction for 1987 was
   a. $0
   b. $1,000
   c. $1,500
   d. $4,500

2M88#24. If a corporation's charitable contributions exceed the limitation for deductibility in a particular year, the excess
   a. May be carried back to the third preceding year.
   b. May be carried forward to a maximum of five succeeding years.
   c. May be carried back or forward for one year at the corporation's election.
   d. Is not deductible in any future or prior year.

2M88#25. With regard to the deduction for bad debts in 1988, corporations that are not financial institutions
   a. May take a deduction for a reasonable addition to a "reserve" for bad debts, if the reserve method was consistently used in prior years.
   b. May change from the direct charge-off method to the reserve method, if approval is requested from the IRS.
   c. Must use the direct charge-off method rather than the reserve method.
   d. May elect either the reserve method or the direct charge-off method, if the election is made in the corporation's first taxable year.

2M88#26. In 1987, Roe Corp. purchased and placed in service a machine to be used in its manufacturing operations. This machine cost $201,000. What portion of the cost may Roe elect to treat as an expense rather than as a capital expenditure?
   a. $0
   b. $9,000
   c. $10,000
   d. $20,100

2M88#27. For the year ended December 31, 1987, Dodd Corp. had net income per books of $100,000. Included in the computation of net income were the following items:
   a. Provision for federal income tax $27,000
   b. Net long-term capital loss 5,000
   c. Keyman life insurance premiums (corporation is beneficiary) 3,000

Dodd's 1987 taxable income was
   a. $127,000
   b. $130,000
   c. $132,000
   d. $135,000

2M88#28. Consolidated returns may be filed
   a. Either by parent-subsidiary corporations or by brother-sister corporations.
   b. Only by corporations that formally request advance permission from the IRS.
   c. Only by parent-subsidiary affiliated groups.
   d. Only by corporations that issue their financial statements on a consolidated basis.

2M87 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

AP-124
Amortization of organization costs (total organization costs of $6,000 were incurred in January 1904, 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 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

2N87#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

2N87#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.

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. $3,000
   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

2N86#44. In 1985, Daly Corp. had the following income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit from operations</td>
<td>$100,000</td>
</tr>
<tr>
<td>Dividends from unrelated taxable domestic corporation</td>
<td>1,000</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. file 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision for state corporation income tax</td>
<td>$3,000</td>
</tr>
<tr>
<td>Interest income on United States obligations</td>
<td>8,000</td>
</tr>
<tr>
<td>Interest paid on loan to carry United States obligations</td>
<td>2,000</td>
</tr>
</tbody>
</table>

How much was Kork’s 1985 taxable income?
   a. $292,000
   b. $294,000
   c. $300,000
   d. $303,000

2N86#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#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

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 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 maximum of 5 succeeding years.
c. May be carried back to the third preceding year.
d. Reduces the corporation's capital loss carryback for that year.

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.

Selected Questions

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

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 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 maximum of 5 succeeding years.
c. May be carried back to the third preceding year.
d. Reduces the corporation's capital loss carryback for that year.

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.

AP-127
Accounting Practice

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:
   Proceeds received $100,000
   Cost 70,000
   Par value 5,000

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

47. Assuming that Aki has no portfolio indebtedness, how much is Aki’s dividends-received deduction for 1984?
   a. $0
   b. $ 450
   c. $2,100
   d. $2,550

48. How much net capital loss can Aki deduct in its 1984 return on the sales of stock of unrelated corporations?
   a. $0
   b. $ 7,200
   c. $18,000
   d. $24,000

49. What is the allowable loss that Aki can claim in its 1984 return for the sale of land to Max Carr?
   a. $4,000 Section 1231 loss.
   b. $4,000 Section 1245 loss.
   c. $4,000 Section 1250 loss.
   d. $0.

50. How much can Aki deduct in its 1984 return for the insurance premiums paid on the policy insuring the life of Luke Ross?
   a. $0
   b. $4,000
   c. $5,000
   d. $9,000

51. How much can Aki deduct in its 1984 return for the dividends paid to preferred stockholders and for the interest paid to Ira Farb?
   a. $0
   b. $ 6,000
   c. $20,000
   d. $26,000

52. Aki is writing off its organizational expenditures over the minimum allowable period for tax purposes. How much can Aki deduct in its 1984 return for amortization of organizational expenditures?
   a. $1,000
   b. $1,500
   c. $2,000
   d. $3,000

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:

AP-128
Selected Questions

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 inauguration 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 inauguration 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 non-affiliated 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.

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

B. Tax Computations and Credits

2M88#29. Except for transition property, qualified progress expenditures, and qualified timber property, the regular 10% investment tax credit
   b. Can be carried forward up to a maximum of 18 years.
   c. Can be claimed only if the asset’s estimated useful life is at least three years.
   d. Is available only if the asset qualifies as five-year accelerated cost recovery system property.

2N87#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.

2N87#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:

<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.

2M84#11. In computing a corporation's taxable income, a net capital loss is
   a. Deductible in full in the year sustained.
   b. Deductible to a maximum extent of 50% in the year sustained.
   c. Not deductible at all in the year sustained.
   d. Limited to a maximum deduction of $3,000 in the year sustained.

C. S Corporations

2M88#30. To be eligible for S corporation status, a corporation can
   a. Not have a decedent's estate as a stockholder.
   b. Not have a bankruptcy estate as a stockholder.
   c. Have both voting and nonvoting common stock issued and outstanding.
   d. Not have more than 25 stockholders.

2N87#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
Selected Questions

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


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

2M86#50. What is the maximum number of stockholders allowable for eligibility as an S corporation?

a. 5
b. 15
c. 25
d. 35

2M86#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.

2M85#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

2M85#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

2M85#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>

2M84#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.

D. Personal Holding Companies

2M88#31. The personal holding company tax

a. Qualifies as a tax credit that may be used by partners or stockholders to reduce their individual income taxes.
b. May be imposed on both corporations and partnerships.
c. Should be self-assessed by filing a separate schedule with the regular tax return.
d. May be imposed regardless of the number of equal stockholders in a corporation.
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.

Kee Holding Corp. has 80 unrelated equal stockholders. For the year ended December 31, 1987, Kee's income comprised the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net rental income</td>
<td>$1,000</td>
</tr>
<tr>
<td>Commissions earned on sales of franchises</td>
<td>3,000</td>
</tr>
<tr>
<td>Dividends from taxable domestic corporations</td>
<td>90,000</td>
</tr>
</tbody>
</table>

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

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.

Where passive investment income is involved, the personal holding company tax may be imposed

a. On both partnerships and corporations.
b. On companies whose gross income arises solely from rentals, if the lessors render no services to the lessees.
c. If more than 50% of the company is owned by five or fewer individuals.
d. On small business investment companies licensed by the Small Business Administration.

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.

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.

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. Can not be imposed on a corporation that has undistributed earnings and profits of less than $150,000.

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.

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.

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.
Selected Questions

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.

2M84#12. The accumulated earnings tax does not apply to corporations that
   a. Have more than one class of stock.
   b. Are personal holding companies.
   c. Are members of a controlled group.
   d. Are manufacturing enterprises.

F. Distributions

2M87#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

2M85#53. The following information pertains to Peel Corp.:

Accumulated earnings and profits at
   January 1, 1984 $15,000

Earnings and profits for the year ended
   December 31, 1984 18,000

Dividends distributed to individual 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

2N84 Items 46 through 52 are based on the following data:

Max Finch was the sole stockholder of Burr, Inc., a company engaged principally in manufacturing 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on sale of land used in business</td>
<td>$10,000</td>
</tr>
<tr>
<td>Loss on sale of long-term investments in marketable securities</td>
<td>15,000</td>
</tr>
<tr>
<td>Dividend income from unaffiliated domestic taxable corporations</td>
<td>2,000</td>
</tr>
<tr>
<td>Keyman insurance premiums paid on Finch's life (Burr is beneficiary)</td>
<td>3,000</td>
</tr>
<tr>
<td>Group life insurance premiums paid on employees' lives (employees' dependents are beneficiaries)</td>
<td>9,000</td>
</tr>
<tr>
<td>Advertising Burr's products in the convention program of a political party</td>
<td>5,000</td>
</tr>
<tr>
<td>Ticket for Burr's sales manager to attend the state governor's inaugural ball</td>
<td>300</td>
</tr>
<tr>
<td>Amortization of organization costs</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Total organization costs of $12,000 were incurred in January 1980, and are being amortized over a 12-year period for financial statement purposes. On July 1, 1983, Burr sold to Finch a plot of land that Burr was not using in its business. The sales price was $90,000, which was also Burr's cost two years earlier. Fair market value of this land was $120,000 on July 1, 1983. In May 1984, Burr sold 100 shares of its $10 par value common stock to Al Hodge for $5,000, the fair market value at that date.

50. Finch should personally treat his $90,000 purchase of the land as a
   a. $30,000 dividend.
   b. $30,000 long-term capital gain.
   c. $30,000 Section 1231 gain.
   d. Nontaxable transaction.

2M84 Items 8 through 10 are based on the following data:

Pym, Inc., which had earnings and profits of $100,000, distributed land to Alex Rowe, a stockholder, as a dividend in kind. Pym's adjusted basis for this land was $3,000. The land had a fair market value of $12,000 and was subject to a mortgage liability of $5,000, which was assumed by Rowe.

9. Before the dividend exclusion, how much of the distribution was taxable to Rowe as a dividend?
   a. $9,000
   b. $7,000
   c. $4,000
   d. $3,000
Accounting Practice

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

G. Tax-Free Incorporation

2M88#34. In 1987, Dr. James Pyle, a cash basis taxpayer, incorporated his dental practice. No liabilities were transferred. The following assets were transferred to the corporation:

   Cash (checking account)          $1,000
   Equipment                       
      Adjusted basis               60,000
      Fair market value            68,000

Immediately after the transfer, Pyle owned 100% of the corporation's stock. The corporation's total basis for the transferred assets is
   a. $69,000
   b. $68,000
   c. $61,000
   d. $60,000

2M87#45. To qualify for tax-free incorporation, a sole proprietor must be in control of the transferee corporation immediately after the exchange of the proprietorship's assets for the corporation's stock. "Control" for this purpose means ownership of stock amounting to at least
   a. 80.00%
   b. 66.67%
   c. 51.00%
   d. 50.00%

2M84#20. James Bell, CPA, a sole practitioner reporting on the cash basis, incorporated his accounting practice in 1984, transferring the following assets to the newly formed corporation:

   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

H. Reorganizations

2M88#32. The accumulated earnings tax does not apply to
   a. Corporations that have more than 100 stockholders.
   b. Personal holding companies.
   c. Corporations filing consolidated returns.
   d. Corporations that have more than one class of stock.

2M87#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.

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>$86,000</td>
</tr>
<tr>
<td>b. $11,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>c. $0</td>
<td>$86,000</td>
</tr>
<tr>
<td>d. $0</td>
<td>$75,000</td>
</tr>
</tbody>
</table>
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.

2M85#42. Lark Corp. and its wholly-owned subsidiary, Day Corp., both operated on a calendar year. In January 1984 Day adopted a plan of complete liquidation. Two months later, Day paid all of its liabilities and distributed its remaining assets to Lark. These assets consisted of the following:

<table>
<thead>
<tr>
<th>Cash</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land (at cost)</td>
<td>10,000</td>
</tr>
</tbody>
</table>

Fair market value of the land was $30,000. Upon distribution of Day's assets to Lark, all of Day's capital stock was cancelled. Lark's basis for the Day stock was $7,000. Lark's recognized gain in 1984 on receipt of Day's assets in liquidation was
a. $0
b. $50,000
c. $53,000
d. $73,000

2M86#59. In 1987, Aca 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, Aca had 100 equal stockholders, and the fair market value of all of Aca's outstanding stock was $12,000,000. In Aca's 1987 return, what amount should be reported as long-term capital gain?
- a. $20,000
- b. $10,000
- c. $8,000
- d. $0

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

2M84#6. Tyson Corp. distributed marketable securities in redemption of its stock in a complete liquidation. These securities had a basis of $300,000 and a fair market value of $450,000. What gain does Tyson have as a result of the distribution?
- a. $0
- b. $150,000 capital gain.
- c. $150,000 Section 1231 gain.
- d. $150,000 ordinary gain.

2M88#33. In 1987, Dave Burr acquired a 20% interest in a partnership by contributing a parcel of land. At the time of Burr's contribution, the land had a fair market value of $35,000, an adjusted basis to Burr of $8,000, and was subject to a mortgage of $12,000. Payment of the mortgage was assumed by the partnership. Burr's basis for his interest in the partnership is
- a. $0
- b. $5,600
- c. $8,000
- d. $23,000

2M88#35. On December 31, 1987, Gail Raff received a 10% interest in the capital of Cole & Co., a partnership, for past services rendered. Cole's net assets at December 31 had a basis of $70,000 and a fair market value of $100,000. How much ordinary income should Gail include in her 1987 return for the partnership interest transferred to her by the other partners?
- a. $0
- b. $3,000
- c. $7,000
- d. $10,000

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?
- a. $0
- b. $12,000
- c. $18,000
- d. $30,000
2N84#45. On May 1, 1984, John Alda was admitted to partnership in the firm of Bartok & Benson. Alda's contribution to capital consisted of 500 shares of stock in Asch Corp., purchased in 1973 for $20,000, and which had a fair market value of $100,000 on May 1, 1984. Alda's interest in the partnership's capital and profits is 25%. On May 1, 1984, the fair market value of the partnership's net assets (after Alda was admitted) was $400,000. What was Alda's gain in 1984 on the exchange of the Asch stock for Alda's partnership interest?
   a. $0.
   b. $80,000 ordinary income.
   c. $80,000 long-term capital gain.
   d. $80,000 Section 1231 gain.

2M84#17. Morris Babb, sole proprietor of Babb Fabrics, hired Ken Ryan on January 1, 1981, for an agreed salary and the promise of a 10% partnership capital interest if Ryan continued in Babb's employ until December 31, 1983. On January 1, 1984, when the enterprise's net worth was $100,000, the partnership was formed as agreed. Ryan should treat the receipt of his partnership interest in 1984 as
   a. Nontaxable.
   b. $10,000 ordinary income.
   c. $10,000 short-term capital gain.
   d. $10,000 long-term capital gain.

K. Basis of Partner's Interest

2M87#54. The following information pertains to land contributed by Bea Dott for a 50% interest in a new partnership:
   
   Dott's adjusted basis $42,000  
   Fair market value 150,000  
   Mortgage assumed by partnership 60,000  

   How much is Dott's basis for her partnership interest?
   a. $0
   b. $24,000
   c. $27,000
   d. $42,000

2N86#53. The holding period of property acquired by a partnership as a contribution to the contributing partner's capital account
   a. Includes the period during which the property was held by the contributing partner.
   b. Is subtracted from the period during which the property was held by the contributing partner.
   c. Begins with the date of contribution to the partnership.
   d. Depends on whether the transfer to the partnership results in a gain or a loss to the contributing partner.

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

2N84#55. On July 1, 1984, Ann Arber received a 10% interest in the capital of Totty Associates, a partnership, for past services rendered. Totty'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

L. Determination of Partner's Taxable Income and Partner's Elections

2M88#36. Dunn and Shaw are partners who share profits and losses equally. In the computation of the partnership's 1987 book income of $100,000, guaranteed payments to partners totaling $60,000 and charitable contributions totaling $1,000 were treated as expenses. What amount should be reported as ordinary income on the partnership's 1987 return?
   a. $100,000
   b. $101,000
   c. $160,000
   d. $161,000

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.
Selected Questions

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) 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.

2N84#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.

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

2N87#40. Sara Loy is a member of a four-person equal partnership. In 1987, Sara sold 100 shares of 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.

2N87#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.

2N85#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.

O. Treatment of Liabilities

2N85#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

2N87

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>Cash</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$11,000</td>
<td></td>
<td>$11,000</td>
</tr>
<tr>
<td>$5,000</td>
<td>12,500</td>
<td></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

2N86#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.

2N85#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

Q. Termination of Partnership

2M88#37. On November 1, 1987, Kerry and Payne, each of whom was a 20% partner in the calendar-year partnership of Roe Co., sold their partnership interests to Reed, who was a 60% partner. For tax purposes, the Roe Co. partnership
   a. Was terminated as of November 1, 1987.
   c. Continues in effect until a formal partnership dissolution notice is filed with the IRS.
   d. Continues in effect until a formal partnership dissolution resolution is filed in the office of the county clerk where Roe Co. had been doing business.

2N87#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.

2N85#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.

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:
Selected Questions

Assets

<table>
<thead>
<tr>
<th>Adjusted basis per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$51,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$51,000</td>
</tr>
</tbody>
</table>

Liabilities and Capital

| Note payable | $30,000 | $30,000 |
| Capital accounts |       |         |
| Hager          | 7,000   | 77,000  |
| Mazer          | 7,000   | 77,000  |
| Slagle         | 7,000   | 77,000  |
| Totals         | $51,000 | $261,000 |

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

R. Types of Organizations

2M87#39. A condominium management association wishing to be treated as a homeowners association and to qualify as an exempt organization for a particular year
   a. Need not file a formal election.
   b. Must file an election as of the date the association was organized.
   c. Must file an election at the beginning of the association’s first taxable year.
   d. Must file a separate election for each taxable year no later than the due date of the return for which the election is to apply.

2N87#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. Can not, under any circumstances, be a foreign corporation.

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.

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

2M88#40. An organization wishing to qualify as an exempt organization
   a. Is prohibited from issuing capital stock.
   b. Is limited to three prohibited transactions a year.
   c. Must not have non-U.S. citizens on its governing board.
   d. Must be of a type specifically identified as one of the classes on which exemption is conferred by the Code.

2N87#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.
Accounting Practice

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 not 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

2M88#38. An exempt organization subject to tax on its 1988 unrelated business income
   a. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations.
   b. Must pay at least 50% of the tax due as shown on the return when filed, with the balance of tax payable six months later.
   c. May defer payment of the tax for up to nine months following the due date of the return.
   d. May elect to make installment payments of estimated tax but is not required to do so.

2N87#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.

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

E. Consolidated Financial Statements

| 1M88#10 b | 1M88#14 b | 1M88#17 c | 2M87# 6 a |
| 1M88#11 a | 1M88#15 c | 2M87# 4 b | 2M87# 7 c |
| 1M88#13 a | 1M88#16 c | 2M87# 5 c | 2M87# 9 d |

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

A. Cash, Marketable Securities, and Investments

| 1N87# 7 c | 1M85#10 c | 1N84#11 c |
| 1M87# 2 c | 1M85#13 b | 1N84#12 c |
| 1M87# 6 c | 1N84# 6 c | 1N84#13 c |
| 1M87#12 a | 1N84# 7 a | 1N84#15 b |
| 2N86# 3 d | 1M84# 6 b | 1N84#16 a |
| 2N86# 4 c | 1M84# 7 b | 1N84#20 c |
| 2N86#16 c | 1M84# 5 b | 1M84# 8 d |
| 1M86# 6 c | 1M84# 9 d | 1M84# 9 d |
| 1N87# 2 b | 1M86# 7 d | 1M84#10 c |
| 1N87# 3 c | 1M86# 9 c | 1M84#11 d |
| 1N87# 6 c | 1N85# 3 c | 1M84#13 c |
| 1N87# 1 b | 1N85# 4 b | 1M84#14 b |
| 1N87# 3 a | 1M85# 5 c | 1M84#15 c |
| 1N87# 4 a | 1M85# 6 a | 1M84#16 b |
| 1M87#19 b | 1M85# 7 a | 1M84#17 c |
| 2N86#15 b | 1M87# 9 a | 1M84#18 b |
| 1M86# 1 a | 1N84# 3 d | 1M84#19 b |
| 1M86# 2 b | 1N84# 4 a | 1M84#20 b |
| 1M86# 3 c | 1M86# 5 c | 1M84#21 b |
| 1N85# 2 d | 2N86# 6 b | 1M86# 7 c |
| 1M85# 1 c | 1M88# 21 d | 1M86#10 c |
| 1M85# 2 b | 1M88#22 c | 2N86# 7 b |
| 1M85# 3 b | 1N87# 5 a | 2N86# 8 d |
| 1N84# 1 a | 1M87#16 b | 1M87#20 b |
| 1N84# 2 d | 1M87#17 d | 1N86# 1 d |
| 1M84# 1 d | 1M86#15 d | 1N86# 5 b |
| 1M84# 2 b | 1M86#16 c | 1M86# 8 a |
| 1M84# 4 a | 1M86#17 c | 1M86#11 b |
| 1M86# 10 c | 1M86#19 d | 1M86#14 a |
| 1M88#19 d | 1N85# 11 a | 1M86#18 d |
| 1M88#20 b | 1N85# 12 d | 1M85# 13 d |
| 1N87# 4 b | 1N85# 13 d | 1M85# 19 c |
| 1M85# 9 b | 1M85# 15 b | 1M85#20 b |
| 1N85# 10 a | 1M85# 19 b | 1N84# 14 d |
| 1N84# 9 a | 1M85# 26 b | 1N84# 16 d |
| 1N84#10 d | 1N85# 11 c | 1N84#36 b |

B. Receivables and Accruals

| 1M85# 5 b | 1M85#11 c | 1N84# 58 d |
| 1M85# 9 b | 1M85#11 c | 1M84#15 c |
| 1M85# 10 a | 1N84# 9 a | 1M84#17 b |
| 1M85# 8 d | 1N84#10 d | 1M84#17 b |

C. Inventories

| 1N85# 6 b | 1M88#21 d | 1M88#26 b |
| 1M85# 1 c | 1M88#22 c | 2N86# 7 b |
| 1M85# 2 b | 1N87# 5 a | 2N86# 8 d |
| 1M85# 3 b | 1M87#16 b | 1M87#20 b |
| 1M84# 1 a | 1M87#17 d | 1N86# 1 d |
| 1M84# 2 d | 1M86#15 d | 1N86# 5 b |
| 1M84# 1 d | 1M86#16 c | 1M86# 8 a |
| 1M84# 2 b | 1M86#17 c | 1M86#11 b |
| 1M84# 4 a | 1M86#19 d | 1M86#14 a |
| 1M86# 10 c | 1M86#11 b | 1M86#18 d |
| 1M85# 13 d | 1N85# 11 a | 1M85# 19 c |
| 1M85# 4 b | 1N85# 12 d | 1M85#20 b |
| 1M86# 15 b | 1N85# 13 d | 1N84# 14 d |
| 1N85# 9 b | 1N85# 19 b | 1N84# 16 d |
| 1N85# 5 b | 1M85# 26 b | 1N84# 36 b |
| 1N85# 10 a | 1N85# 11 c | 1N84# 58 d |
| 1N84# 9 a | 1M84# 9 a | 1M84#15 c |
| 1N84#10 d | 1M84#10 d | 1M84#17 b |

D. Property, Plant, and Equipment Owned or Leased

| 1M85# 23 b | 1M88#26 b |
| 1M85# 24 a | 1M88#10 c |
| 1M85# 25 c | 1M84#11 d |
| 1M85# 7 a | 1M84#13 c |
| 1M85# 8 c | 1M84#14 b |
| 1M87# 9 d | 1N86# 2 a |
| 1N86# 3 c | 1N86# 10 d |
| 2N86# 2 d | 1N87# 11 b |
| 2N86# 7 b | 1M87#10 c |
| 2N86# 8 d | 1M87#20 b |
| 1N86# 1 d | 1N86# 5 b |
| 1M86# 11 b | 1M86# 8 a |
| 1M86# 14 a | 1M86#19 c |
| 1M86# 18 d | 1M85#20 c |
| 1N86# 14 b | 1N84#14 d |
| 1N84# 36 b | 1N84# 58 d |
| 1M84#15 c | 1M84#17 b |

E. Intangibles and Other Assets

| 1M88#26 b | 1M85# 26 b |
| 1M88#10 c | 1M85#10 c |
| 1M87#20 b | 1N86# 10 d |
| 1N86# 11 b | 1N87# 10 d |
| 1M86# 19 b | 1N85# 8 a |
| 1M86# 20 c | 1M86#11 b |
| 1M86# 14 a | 1M85#19 c |
| 1M86# 18 d | 1M85#20 c |
| 1M84#14 d | 1N84# 16 d |
| 1N84# 36 b | 1N84# 58 d |
| 1M84#15 c | 1M84#17 b |
### III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

**A. Payables and Accruals**

<table>
<thead>
<tr>
<th>Date</th>
<th>Type</th>
<th>Description</th>
<th>Date</th>
<th>Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2M85</td>
<td>7 d</td>
<td>Accrued Payables</td>
<td>1N87</td>
<td>24 c</td>
<td>Expenses</td>
</tr>
<tr>
<td>1M84</td>
<td>20 d</td>
<td>Accounts Payable</td>
<td>1M87</td>
<td>21 c</td>
<td>Interest</td>
</tr>
<tr>
<td>1M87</td>
<td>31 b</td>
<td>Liabilities</td>
<td>1M86</td>
<td>37 a</td>
<td>Dividends</td>
</tr>
<tr>
<td>1M85</td>
<td>8 a</td>
<td>Payable Liability</td>
<td>2M86</td>
<td>8 a</td>
<td>Treasury</td>
</tr>
<tr>
<td>1N86</td>
<td>30 b</td>
<td>Debt</td>
<td>2M86</td>
<td>17 b</td>
<td>Other</td>
</tr>
<tr>
<td>1N87</td>
<td>32 c</td>
<td>Payable</td>
<td>2M86</td>
<td>20 b</td>
<td>Stocks</td>
</tr>
<tr>
<td>1N87</td>
<td>14 c</td>
<td>Payable</td>
<td>1N85</td>
<td>21 a</td>
<td>Bonds</td>
</tr>
<tr>
<td>1N87</td>
<td>15 c</td>
<td>Payable</td>
<td>1N85</td>
<td>24 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N87</td>
<td>18 d</td>
<td>Payable</td>
<td>1N85</td>
<td>31 c</td>
<td>Capitalized Lease</td>
</tr>
<tr>
<td>1N87</td>
<td>19 d</td>
<td>Payable</td>
<td>2M85</td>
<td>4 b</td>
<td>Real Estate</td>
</tr>
<tr>
<td>1N85</td>
<td>5 d</td>
<td>Payable</td>
<td>2M85</td>
<td>5 d</td>
<td>Leases</td>
</tr>
<tr>
<td>1N85</td>
<td>13 c</td>
<td>Payable</td>
<td>1N84</td>
<td>24 d</td>
<td>Other</td>
</tr>
<tr>
<td>1M85</td>
<td>11 a</td>
<td>Payable</td>
<td>1M84</td>
<td>40 c</td>
<td>Dividends</td>
</tr>
<tr>
<td>1M85</td>
<td>15 d</td>
<td>Payable</td>
<td>1M85</td>
<td>37 a</td>
<td>Interest</td>
</tr>
<tr>
<td>1N86</td>
<td>4 d</td>
<td>Payable</td>
<td>1M85</td>
<td>28 b</td>
<td>Expense</td>
</tr>
<tr>
<td>1N86</td>
<td>6 c</td>
<td>Payable</td>
<td>1M85</td>
<td>29 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>7 a</td>
<td>Payable</td>
<td>1M85</td>
<td>31 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>8 a</td>
<td>Payable</td>
<td>1M85</td>
<td>35 c</td>
<td>Payable</td>
</tr>
<tr>
<td>2M86</td>
<td>15 b</td>
<td>Payable</td>
<td>1M87</td>
<td>27 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>14 a</td>
<td>Payable</td>
<td>1M86</td>
<td>28 b</td>
<td>Payable</td>
</tr>
<tr>
<td>2M86</td>
<td>10 a</td>
<td>Payable</td>
<td>1M87</td>
<td>29 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>12 d</td>
<td>Payable</td>
<td>1M87</td>
<td>30 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>13 b</td>
<td>Payable</td>
<td>1M86</td>
<td>23 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>14 a</td>
<td>Payable</td>
<td>1M87</td>
<td>37 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>15 a</td>
<td>Payable</td>
<td>1N86</td>
<td>24 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>16 a</td>
<td>Payable</td>
<td>1N85</td>
<td>25 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>17 b</td>
<td>Payable</td>
<td>2M86</td>
<td>5 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1M87</td>
<td>5 d</td>
<td>Payable</td>
<td>1N84</td>
<td>24 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1M87</td>
<td>13 c</td>
<td>Payable</td>
<td>1M84</td>
<td>40 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1M87</td>
<td>11 a</td>
<td>Payable</td>
<td>1M85</td>
<td>37 a</td>
<td>Payable</td>
</tr>
<tr>
<td>1M87</td>
<td>15 d</td>
<td>Payable</td>
<td>1M85</td>
<td>28 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>4 d</td>
<td>Payable</td>
<td>1M85</td>
<td>29 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>6 c</td>
<td>Payable</td>
<td>1M85</td>
<td>31 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>7 a</td>
<td>Payable</td>
<td>1M85</td>
<td>35 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>8 a</td>
<td>Payable</td>
<td>1M85</td>
<td>27 d</td>
<td>Payable</td>
</tr>
<tr>
<td>2M86</td>
<td>10 a</td>
<td>Payable</td>
<td>1N85</td>
<td>24 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>12 d</td>
<td>Payable</td>
<td>2M86</td>
<td>5 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>13 b</td>
<td>Payable</td>
<td>1M85</td>
<td>28 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>14 a</td>
<td>Payable</td>
<td>1M85</td>
<td>29 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>15 a</td>
<td>Payable</td>
<td>1M85</td>
<td>31 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N86</td>
<td>16 a</td>
<td>Payable</td>
<td>1M85</td>
<td>35 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N87</td>
<td>18 d</td>
<td>Payable</td>
<td>1N85</td>
<td>20 a</td>
<td>Stock Options</td>
</tr>
<tr>
<td>2M86</td>
<td>10 a</td>
<td>Payable</td>
<td>1N85</td>
<td>20 a</td>
<td>Warrants</td>
</tr>
<tr>
<td>1N87</td>
<td>21 b</td>
<td>Payable</td>
<td>2M85</td>
<td>3 b</td>
<td>Rights</td>
</tr>
<tr>
<td>2M86</td>
<td>23 b</td>
<td>Payable</td>
<td>2M85</td>
<td>3 b</td>
<td>Rights</td>
</tr>
</tbody>
</table>

**B. Deferred Revenues**

<table>
<thead>
<tr>
<th>Date</th>
<th>Type</th>
<th>Description</th>
<th>Date</th>
<th>Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1M87</td>
<td>8 b</td>
<td>Deferred Revenues</td>
<td>1N87</td>
<td>18 d</td>
<td>Deferred Revenue</td>
</tr>
<tr>
<td>1M87</td>
<td>31 a</td>
<td>Revenue</td>
<td>1M86</td>
<td>19 c</td>
<td>Expense</td>
</tr>
<tr>
<td>2M86</td>
<td>18 b</td>
<td>Revenue</td>
<td>2M86</td>
<td>20 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>21 a</td>
<td>Revenue</td>
<td>1N85</td>
<td>24 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>31 c</td>
<td>Revenue</td>
<td>2M85</td>
<td>4 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>18 d</td>
<td>Revenue</td>
<td>1M84</td>
<td>24 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>19 d</td>
<td>Revenue</td>
<td>1M85</td>
<td>23 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>15 c</td>
<td>Revenue</td>
<td>2M85</td>
<td>5 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>18 d</td>
<td>Revenue</td>
<td>1N84</td>
<td>24 d</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>19 d</td>
<td>Revenue</td>
<td>1M84</td>
<td>40 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>14 c</td>
<td>Revenue</td>
<td>1M85</td>
<td>37 a</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>13 c</td>
<td>Revenue</td>
<td>1M85</td>
<td>28 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>12 d</td>
<td>Revenue</td>
<td>1M85</td>
<td>29 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N85</td>
<td>15 b</td>
<td>Revenue</td>
<td>1M85</td>
<td>31 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N84</td>
<td>26 b</td>
<td>Revenue</td>
<td>1N85</td>
<td>35 c</td>
<td>Payable</td>
</tr>
<tr>
<td>1N84</td>
<td>24 d</td>
<td>Revenue</td>
<td>1N85</td>
<td>20 a</td>
<td>Payable</td>
</tr>
<tr>
<td>1N84</td>
<td>28 c</td>
<td>Revenue</td>
<td>2M85</td>
<td>3 b</td>
<td>Payable</td>
</tr>
<tr>
<td>1N84</td>
<td>29 a</td>
<td>Revenue</td>
<td>1N84</td>
<td>25 c</td>
<td>Payable</td>
</tr>
</tbody>
</table>

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

**A. Preferred and Common Stock**

<table>
<thead>
<tr>
<th>Date</th>
<th>Type</th>
<th>Description</th>
<th>Date</th>
<th>Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1M88</td>
<td>42 b</td>
<td>Preferred Stock</td>
<td>1M88</td>
<td>43 b</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1N86</td>
<td>25 b</td>
<td>Preferred</td>
<td>1N87</td>
<td>32 d</td>
<td>Dividends</td>
</tr>
<tr>
<td>1N86</td>
<td>26 c</td>
<td>Preferred</td>
<td>2N85</td>
<td>16 b</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1N86</td>
<td>28 b</td>
<td>Preferred</td>
<td>1M85</td>
<td>25 a</td>
<td>Common Stock</td>
</tr>
<tr>
<td>2N85</td>
<td>12 c</td>
<td>Preferred</td>
<td>1M85</td>
<td>21 b</td>
<td>Common Stock</td>
</tr>
<tr>
<td>2N85</td>
<td>13 c</td>
<td>Preferred</td>
<td>1N84</td>
<td>20 a</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1M85</td>
<td>14 d</td>
<td>Preferred</td>
<td>1N86</td>
<td>21 b</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1M85</td>
<td>15 b</td>
<td>Preferred</td>
<td>1N86</td>
<td>22 a</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1N84</td>
<td>26 b</td>
<td>Preferred</td>
<td>2M85</td>
<td>3 b</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1N84</td>
<td>27 c</td>
<td>Preferred</td>
<td>1N84</td>
<td>25 c</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1N86</td>
<td>27 d</td>
<td>Preferred</td>
<td>1M86</td>
<td>30 c</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1M85</td>
<td>16 d</td>
<td>Preferred</td>
<td>1N84</td>
<td>40 a</td>
<td>Common Stock</td>
</tr>
</tbody>
</table>

**B. Additional Paid-in Capital**

<table>
<thead>
<tr>
<th>Date</th>
<th>Type</th>
<th>Description</th>
<th>Date</th>
<th>Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1N86</td>
<td>27 d</td>
<td>Additional</td>
<td>1M86</td>
<td>36 c</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1M85</td>
<td>16 d</td>
<td>Paid-in</td>
<td>2N85</td>
<td>10 c</td>
<td>Common Stock</td>
</tr>
<tr>
<td>2N85</td>
<td>11 b</td>
<td>Capital</td>
<td>1M85</td>
<td>22 b</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1M85</td>
<td>26 c</td>
<td>Paid-in</td>
<td>1N84</td>
<td>18 b</td>
<td>Common Stock</td>
</tr>
<tr>
<td>1N84</td>
<td>18 b</td>
<td>Paid-in</td>
<td>1N84</td>
<td>34 c</td>
<td>Common Stock</td>
</tr>
</tbody>
</table>
**Unofficial Answers**

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

<table>
<thead>
<tr>
<th>A. Revenues and Gains</th>
<th>B. Expenses and Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1N85# 34 d 1N86# 44 d</td>
<td>1N85# 35 d 1N86# 45 c</td>
</tr>
<tr>
<td>1N85# 36 d 1N86# 46 c</td>
<td>1N85# 39 b 1N86# 47 c</td>
</tr>
<tr>
<td>1M87# 21 b 1M85# 23 b</td>
<td>1M87# 27 d 1N85# 49 d</td>
</tr>
<tr>
<td>1N85# 30 c 1N86# 50 d</td>
<td>1M85# 31 b 2N86# 6 d</td>
</tr>
<tr>
<td>1N87# 32 d 1M85# 32 b</td>
<td>1N86# 14 c 1M86# 59 d</td>
</tr>
<tr>
<td>1N87# 33 a 1M86# 33 b</td>
<td>1N86# 42 d 2N86# 9 a</td>
</tr>
<tr>
<td>1N87# 36 c 1M86# 43 b</td>
<td>1M85# 10 b 1M86# 41 b</td>
</tr>
<tr>
<td>1N87# 37 c 1M85# 34 a</td>
<td>1M86# 44 b 1M86# 59 a</td>
</tr>
<tr>
<td>1N87# 38 b 1M86# 45 d</td>
<td>1M85# 46 c 1N85# 48 a</td>
</tr>
<tr>
<td>1N87# 39 a 1M86# 47 a</td>
<td>1M86# 48 d 1M85# 48 d</td>
</tr>
<tr>
<td>1M87# 35 c 1M85# 50 c</td>
<td>1N85# 54 a 1N85# 19 b</td>
</tr>
<tr>
<td>1M87# 36 d 1N84# 38 c</td>
<td>1N86# 55 a 1N84# 37 a</td>
</tr>
<tr>
<td>1M87# 39 d 1M84# 39 a</td>
<td>1N86# 56 d 1M84# 42 d</td>
</tr>
<tr>
<td>2M87# 1 a 1N86# 41 d</td>
<td>1M86# 60 c 1M84# 44 a</td>
</tr>
<tr>
<td>2M87# 2 b 1N84# 42 c</td>
<td>1N85# 37 c 1N85# 38 b</td>
</tr>
<tr>
<td>2M87# 3 c 1N84# 43 d</td>
<td>1N85# 40 c 1N85# 41 b</td>
</tr>
<tr>
<td>2M87# 13 d 1N84# 47 a</td>
<td>1N85# 42 a 1N87# 51 b</td>
</tr>
<tr>
<td>2M87# 14 b 1N84# 48 b</td>
<td>1N85# 43 b 1M87# 47 c</td>
</tr>
<tr>
<td>2M87# 15 c 1N85# 35 a</td>
<td>1N85# 44 d 2N86# 11 a</td>
</tr>
<tr>
<td>2M87# 16 d 1N84# 22 a</td>
<td>1N85# 46 c 2N86# 12 c</td>
</tr>
<tr>
<td>2M87# 17 c 1N84# 28 b</td>
<td>1N85# 31 c 1N85# 51 b</td>
</tr>
<tr>
<td>2M87# 19 d 1N84# 31 c</td>
<td>1N85# 42 a 1M87# 47 c</td>
</tr>
<tr>
<td>2M87# 20 a 1N84# 32 b</td>
<td>1N85# 43 b 2N86# 11 a</td>
</tr>
<tr>
<td>1N86# 29 c 1N85# 44 d</td>
<td>1N85# 46 c 2N86# 12 c</td>
</tr>
<tr>
<td>1N86# 30 a 1N85# 54 a</td>
<td>1M85# 35 a 1N86# 57 a</td>
</tr>
<tr>
<td>1N86# 34 a</td>
<td>1M85# 36 d 1M86# 58 c</td>
</tr>
<tr>
<td>1N86# 37 b</td>
<td>1N85# 38 c 1N85# 49 b</td>
</tr>
<tr>
<td></td>
<td>1N85# 40 c 1N85# 50 d</td>
</tr>
<tr>
<td></td>
<td>1N85# 41 c 1M85# 28 c</td>
</tr>
<tr>
<td></td>
<td>1N85# 43 b 1M85# 49 c</td>
</tr>
<tr>
<td></td>
<td>1N85# 44 a 1N84# 60 d</td>
</tr>
<tr>
<td></td>
<td>1N86# 38 c 1N85# 49 b</td>
</tr>
<tr>
<td></td>
<td>1N86# 40 c 1N85# 50 d</td>
</tr>
<tr>
<td></td>
<td>1N86# 42 a 1M85# 28 c</td>
</tr>
<tr>
<td></td>
<td>1N86# 43 b 1M85# 49 c</td>
</tr>
<tr>
<td></td>
<td>1N86# 51 d 1N84# 60 d</td>
</tr>
<tr>
<td></td>
<td>1M86# 37 c 1N86# 51 c</td>
</tr>
<tr>
<td></td>
<td>1M86# 41 a 1N86# 52 b</td>
</tr>
<tr>
<td></td>
<td>1M86# 45 d 2N86# 51 b</td>
</tr>
<tr>
<td></td>
<td>1M86# 46 c 2N86# 52 b</td>
</tr>
<tr>
<td></td>
<td>1M86# 49 b 1N85# 58 b</td>
</tr>
<tr>
<td></td>
<td>1M86# 51 c 1M87# 58 b</td>
</tr>
<tr>
<td></td>
<td>1M86# 52 a 1N85# 49 b</td>
</tr>
<tr>
<td></td>
<td>1M86# 53 c 2M87# 8 d</td>
</tr>
<tr>
<td></td>
<td>1M86# 54 a 2N86# 17 b</td>
</tr>
<tr>
<td></td>
<td>1M86# 55 d 2N86# 18 a</td>
</tr>
<tr>
<td></td>
<td>1N86# 56 b 1M86# 51 b</td>
</tr>
<tr>
<td></td>
<td>1N86# 57 c 1N86# 52 b</td>
</tr>
<tr>
<td></td>
<td>1N86# 58 c 1N85# 54 c</td>
</tr>
<tr>
<td></td>
<td>1N86# 59 d 1N85# 55 d</td>
</tr>
<tr>
<td></td>
<td>1N86# 60 d 1N85# 54 c</td>
</tr>
<tr>
<td></td>
<td>1N86# 61 b 1N85# 55 d</td>
</tr>
<tr>
<td></td>
<td>1M86# 52 b 1N85# 55 d</td>
</tr>
<tr>
<td></td>
<td>1M86# 53 b 1N85# 54 c</td>
</tr>
<tr>
<td></td>
<td>1M86# 54 c 1M84# 48 c</td>
</tr>
<tr>
<td></td>
<td>1N86# 55 d 1M84# 49 d</td>
</tr>
</tbody>
</table>

D. Recurring Versus Nonrecurring Transactions and Events

E. Accounting Changes

F. Earnings Per Share

AP-143
### VI. Other Financial Topics

#### A. Disclosures in Notes to the Financial Statements

- **1M88#46 d**
  - 1M88#55 d
  - 1N86#59 b
  - 1N85#55 d
  - 2N84#5 a
  - 1M84#56 b

#### C. Nonmonetary Transactions

- **1M85#52 a**
  - 1N87#55 a
  - 1N87#54 d
  - 2N84# 9 b
  - 1N85#53 c

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

- **1N86#55 c**
  - 2M88# 6 c
  - 1N85#60 a
  - 1M85#59 c
  - 2N84# 7 c
  - 1M84#56 b

#### J. Development Stage Enterprises

- **1M88#60 a**
  - 1M88#53 a
  - 1N85#51 a
  - 1N85#57 d
  - 1N85#58 a
  - 1M85#60 c

#### K. Personal Financial Statements

- **1N88#59 b**
  - 2N84# 4 d
  - 2N84# 5 a
  - 1M84# 56 b

#### F. Gain Contingencies

- **1M88#56 d**
  - 1N86#51 a
  - 1N85#52 a
  - 1N85#58 a
  - 1N85#54 d
  - 1M84#55 a

#### I. Analysis of Financial Statements

- **1N88#56 b**
  - 1N85#58 b
  - 2N84# 10 c
  - 1M85#57 d
  - 1M84#55 d

#### L. Combined Financial Statements

- **1M88#60 a**
  - 1N85#51 c
  - 1N85#59 c
  - 1M87#60 c
  - 2M86# 13 d

### VII. Cost Accumulation, Planning, and Control

#### A. Nature of Cost Elements

- **2M87#23 a**
  - 2M87#24 c
  - 2N86# 29 c
  - 2N85# 1 c
  - 2N85# 2 a

#### B. Process and Job Order Costing

- **2M87#40 a**
  - 2N86# 27 a
  - 2N86# 38 c
  - 2N86# 40 a
  - 2N86# 25 d

#### C. Standard Costing

- **2M87#32 c**
  - 2M86# 29 b
  - 2N84# 17 c
  - 2M86# 21 b
  - 2M86# 28 a

#### D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

- **2M87#31 c**
  - 2N86# 37 b
  - 2N86# 29 d
  - 2N86# 26 a
  - 2N86# 24 a
  - 2N86# 34 a

#### E. Absorption and Variable Costing

- **2M86#30 d**
  - 2N84# 14 b
  - 2N84# 15 b
  - 2M87#37 b
  - 2N86# 31 a
  - 2N86# 32 d

#### H. Capital Budgeting Techniques

- **2N86# 33 b**
  - 2N85# 7 a
  - 2N85# 8 a
  - 2M87#38 b
  - 2N85# 13 c
  - 2N84# 18 b

#### F. Budgeting and Flexible Budgeting

- **2M87#39 c**
  - 2N86# 26 c
  - 2M87#34 b
  - 2N86# 24 a
  - 2N86# 34 b
  - 2M86# 27 c
  - 2N86# 22 b

#### G. Breakeven and Cost-Volume-Profit Analysis

- **2N85#6 c**
  - 2N86# 29 c
  - 2N86# 23 d

AP-144
Unofficial Answers

<table>
<thead>
<tr>
<th>A. Fund Accounting</th>
<th>B. Types of Funds and Fund Accounts</th>
<th>C. Exclusions and Adjustments to Arrive at Adjusted Gross Income</th>
<th>D. Various Types of Not-for-Profit and Governmental Organizations</th>
<th>E. Deductions From Adjusted Gross Income</th>
<th>F. Gain or Loss on Property Transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2M88# 25 c</td>
<td>J. Other</td>
<td>2M87# 33 d</td>
<td>2M86# 40 c</td>
<td>2M86# 7 b</td>
<td>2M86# 56 d</td>
</tr>
<tr>
<td>2M86# 37 c</td>
<td></td>
<td>2M86# 21 d</td>
<td>2N86# 9 d</td>
<td>2N85# 12 d</td>
<td>2N86# 57 b</td>
</tr>
<tr>
<td>2M86# 38 d</td>
<td></td>
<td>2N86# 28 c</td>
<td>2N85# 20 a</td>
<td>2M88# 13 c</td>
<td>2N85# 36 d</td>
</tr>
<tr>
<td>2M85# 18 b</td>
<td></td>
<td>2N86# 35 b</td>
<td>2M85# 11 d</td>
<td>2M86# 60 c</td>
<td></td>
</tr>
<tr>
<td>2M85# 19 c</td>
<td></td>
<td>2N86# 36 a</td>
<td>2M85# 14 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>2N86# 40 d</td>
<td>2M85# 17 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>2M86# 31 d</td>
<td>2M85# 20 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>2M86# 32 b</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

VIII. Not-for-Profit and Governmental Accounting

A. Inclusions for Gross Income and Adjusted Gross Income

| 2M88# 1 a          | 2N85# 25 a                           | 2N85# 26 b                                                  | 2N85# 27 a                                                  | 2N85# 28 d                             | 2M88# 15 c                           |
| 2M88# 2 d          | 2N85# 31 b                           | 2N85# 33 d                                                  | 2N85# 21 b                                                  | 2N85# 21 a                             | 2M88# 16 c                           |
| 2M88# 3 d          | 2N85# 33 d                           | 2N85# 21 b                                                  | 2N85# 23 a                                                  | 2N85# 23 a                             | 2N87# 5 d                            |
| 2M88# 4 b          | 2N85# 23 a                           | 2N85# 24 a                                                  | 2N85# 28 d                                                  | 2N85# 22 d                             | 2N86# 39 d                           |
| 2M88# 5 a          | 2N85# 28 c                           | 2N85# 37 c                                                  | 2M84# 21 c                                                  | 2M84# 29 d                             | 2M88# 13 c                           |
| 2M88# 6 d          | 2N85# 29 c                           | 2N85# 37 c                                                  | 2M84# 21 c                                                  | 2M84# 38 d                             | 2M88# 14 a                           |
| 2M88# 9 a          | 2N85# 31 b                           | 2N85# 33 b                                                  | 2M84# 21 c                                                  | 2M84# 39 d                             | 2M86# 36 c                           |
| 2N87# 1 b          | 2N85# 31 b                           | 2M84# 21 c                                                  | 2M84# 29 d                                                  | 2M84# 40 a                             |                                        |
| 2N87# 2 a          | 2N85# 32 c                           | 2M84# 23 a                                                  | 2N87# 18 b                                                  | 2N85# 34 d                             |                                        |
| 2N87# 3 c          | 2N85# 32 c                           | 2M84# 24 d                                                  | 2N87# 19 a                                                  | 2N85# 35 a                             |                                        |
| 2N87# 4 d          | 2N85# 32 c                           | 2N87# 20 a                                                  | 2N85# 36 d                                                  |                                        |                                        |
| 2N87# 6 d          |                                  |                                                            |                                                            |                                        |                                        |
| 2N87# 7 a          |                                  |                                                            |                                                            |                                        |                                        |
| 2N87# 8 c          |                                  |                                                            |                                                            |                                        |                                        |
| 2N87# 9 b          |                                  |                                                            |                                                            |                                        |                                        |
| 2N87# 10 a         |                                  |                                                            |                                                            |                                        |                                        |
| 2M86# 41 a         |                                  |                                                            |                                                            |                                        |                                        |
| 2M86# 42 b         |                                  |                                                            |                                                            |                                        |                                        |
| 2M86# 45 b         |                                  |                                                            |                                                            |                                        |                                        |
| 2M86# 49 d         |                                  |                                                            |                                                            |                                        |                                        |
| 2M86# 52 a         |                                  |                                                            |                                                            |                                        |                                        |
| 2N85# 24 d         |                                  |                                                            |                                                            |                                        |                                        |

IX. Federal Taxation — Individuals, Estates, and Trusts


**Accounting Practice**

<table>
<thead>
<tr>
<th>2N85# 37 c</th>
<th>E. Filing Status and Exemptions</th>
<th>2N85# 30 d</th>
<th>2M88# 19 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>2N85# 38 c</td>
<td>2M85# 36 a</td>
<td>2M88# 20 c</td>
<td></td>
</tr>
<tr>
<td>2N85# 39 a</td>
<td>2N84# 26 c</td>
<td>2N87# 11 c</td>
<td></td>
</tr>
<tr>
<td>2M85# 34 d</td>
<td>2M84# 34 b</td>
<td>2N87# 12 b</td>
<td></td>
</tr>
<tr>
<td>2M85# 35 b</td>
<td>2N87# 13 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2M84# 22 c</td>
<td>2M86# 46 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2N84# 23 a</td>
<td>2N85# 40 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2N84# 24 b</td>
<td>2M85# 25 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2N84# 25 b</td>
<td>2M85# 30 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2N84# 28 b</td>
<td>2M84# 22 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2M84# 30 a</td>
<td>2M84# 36 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2M84# 31 a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2M84# 32 a</td>
<td>2M85# 59 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2M84# 33 a</td>
<td>2N84# 45 b</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**G. Statute of Limitations**

| 2N85# 47 a |
| 2M86# 46 c |
| 2N85# 29 c |
| 2N85# 32 a |
| 2M85# 27 a |
| |
| 2M85# 39 c |

**H. Estate and Gift Taxation and Income Taxation of Estates and Trusts**

| 2N84# 27 a |
| 2M84# 25 a |
| 2M84# 26 b |
| 2M84# 27 b |

**F. Tax Computations and Credits**

| 2M88# 8 d |
| 2M88# 17 c |
| 2M88# 18 b |

**X. Federal Taxation—Corporations, Partnerships, and Exempt Organizations**

| 2M88# 22 d |
| 2M88# 31 d |
| 2M88# 23 a |
| 2M88# 43 d |

<table>
<thead>
<tr>
<th>A. Determination of Taxable Income or Loss</th>
<th>2N85# 49 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>2N85# 50 a</td>
<td></td>
</tr>
<tr>
<td>2M85# 45 b</td>
<td></td>
</tr>
<tr>
<td>2M85# 46 a</td>
<td></td>
</tr>
<tr>
<td>2M85# 47 d</td>
<td></td>
</tr>
<tr>
<td>2M85# 48 a</td>
<td></td>
</tr>
<tr>
<td>2M85# 49 d</td>
<td></td>
</tr>
<tr>
<td>2M85# 50 a</td>
<td></td>
</tr>
<tr>
<td>2M85# 51 b</td>
<td></td>
</tr>
<tr>
<td>2M88# 28 d</td>
<td></td>
</tr>
<tr>
<td>2N84# 48 c</td>
<td></td>
</tr>
<tr>
<td>2N84# 51 a</td>
<td></td>
</tr>
<tr>
<td>2N84# 52 d</td>
<td></td>
</tr>
<tr>
<td>2N84# 51 b</td>
<td></td>
</tr>
<tr>
<td>2N84# 2 b</td>
<td></td>
</tr>
<tr>
<td>2N84# 3 d</td>
<td></td>
</tr>
<tr>
<td>2N84# 5 c</td>
<td></td>
</tr>
<tr>
<td>2N84# 8 c</td>
<td></td>
</tr>
<tr>
<td>2M88# 13 a</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B. Tax Computations and Credits</th>
<th>2M88# 29 a</th>
</tr>
</thead>
<tbody>
<tr>
<td>2N87# 30 c</td>
<td></td>
</tr>
<tr>
<td>2N87# 51 c</td>
<td></td>
</tr>
<tr>
<td>2N86# 43 d</td>
<td></td>
</tr>
<tr>
<td>2N85# 51 a</td>
<td></td>
</tr>
<tr>
<td>2N85# 55 d</td>
<td></td>
</tr>
<tr>
<td>2N84# 59 b</td>
<td></td>
</tr>
<tr>
<td>2M84# 11 c</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>C. S Corporations</th>
<th>2M88# 57 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>2M88# 53 c</td>
<td></td>
</tr>
<tr>
<td>2N84# 50 a</td>
<td></td>
</tr>
<tr>
<td>2M84# 9 b</td>
<td></td>
</tr>
<tr>
<td>2N86# 53 a</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>D. Personal Holding Companies</th>
<th>2M88# 32 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>2N87# 36 a</td>
<td></td>
</tr>
<tr>
<td>2M87# 58 c</td>
<td></td>
</tr>
<tr>
<td>2N86# 45 a</td>
<td></td>
</tr>
<tr>
<td>2M85# 54 d</td>
<td></td>
</tr>
<tr>
<td>2N84# 58 a</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>E. Accumulated Earnings Tax</th>
<th>2M87# 35 d</th>
</tr>
</thead>
<tbody>
<tr>
<td>2M87# 41 a</td>
<td></td>
</tr>
<tr>
<td>2N86# 47 a</td>
<td></td>
</tr>
<tr>
<td>2N85# 52 c</td>
<td></td>
</tr>
<tr>
<td>2M85# 43 b</td>
<td></td>
</tr>
<tr>
<td>2N84# 53 d</td>
<td></td>
</tr>
<tr>
<td>2M84# 12 b</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>F. Distributions</th>
<th>2M84# 57 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>2M88# 53 c</td>
<td></td>
</tr>
<tr>
<td>2N84# 50 a</td>
<td></td>
</tr>
<tr>
<td>2M84# 9 b</td>
<td></td>
</tr>
<tr>
<td>2N86# 53 a</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>G. Tax-Free Incorporation</th>
<th>2M88# 34 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>2M87# 45 a</td>
<td></td>
</tr>
<tr>
<td>2M84# 20 b</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>H. Reorganizations</th>
<th>2M87# 32 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>2N87# 36 a</td>
<td></td>
</tr>
<tr>
<td>2M87# 58 c</td>
<td></td>
</tr>
<tr>
<td>2N86# 45 a</td>
<td></td>
</tr>
<tr>
<td>2M85# 54 d</td>
<td></td>
</tr>
<tr>
<td>2N84# 58 a</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>I. Liquidations and Dissolutions</th>
<th>2M87# 59 a</th>
</tr>
</thead>
<tbody>
<tr>
<td>2N85# 54 d</td>
<td></td>
</tr>
<tr>
<td>2M85# 42 a</td>
<td></td>
</tr>
<tr>
<td>2M84# 6 a</td>
<td></td>
</tr>
<tr>
<td>2M84# 15 c</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>J. Formation of Partnership</th>
<th>2M88# 33 a</th>
</tr>
</thead>
<tbody>
<tr>
<td>2M88# 35 d</td>
<td></td>
</tr>
<tr>
<td>2M87# 53 d</td>
<td></td>
</tr>
<tr>
<td>2N84# 45 a</td>
<td></td>
</tr>
<tr>
<td>2M84# 17 b</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>K. Basis of Partner’s Interest</th>
<th>2M87# 54 a</th>
</tr>
</thead>
<tbody>
<tr>
<td>2N86# 53 a</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>N.</td>
<td>Partner Dealing With Own Partnership</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>I.</td>
<td>Determination of Partner's Taxable Income and Partner's Elections</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Q.</td>
<td>Termination of Partnership</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>O.</td>
<td>Treatment of Liabilities</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>P.</td>
<td>Distribution of Partnership Assets</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>R.</td>
<td>Types of Organizations</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>S.</td>
<td>Requirements for Exemption</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>T.</td>
<td>Unrelated Business Income</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>M.</td>
<td>Accounting Periods of Partnership and Partners</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

AP-147
PROBLEMS — SELECTED QUESTIONS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M87
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>Account</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><strong>Total</strong></td>
<td><strong>$108,000</strong></td>
<td><strong>$108,000</strong></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.

AP-149
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>Assets</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>$1,375,000</td>
<td>$991,000</td>
</tr>
</tbody>
</table>

| Liabilities & Stockholders’ Equity |          |          |
| Accounts payable & accrued liabilities | $420,000 | $347,000 |
| Estimated liability from lawsuit | 100,000 | — |
| Common stock, $10 par | 260,000 | 260,000 |
| Additional paid-in capital | 130,000 | 130,000 |
| Retained earnings | 465,000 | 254,000 |
| Total liabilities & stockholders’ equity | $1,375,000 | $991,000 |

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>Total operating expenses</td>
<td>1,369,000</td>
<td>1,073,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$211,000</td>
<td>$177,000</td>
</tr>
</tbody>
</table>

AP-150
### 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></td>
</tr>
<tr>
<td>Assets:</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>
<tr>
<td>Liabilities &amp; Stockholders' Equity:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable &amp; accrued liabilities</td>
<td>$ 420,000</td>
<td></td>
</tr>
<tr>
<td>Estimated liability from lawsuit</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>260,000</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>130,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, 1/1/85</td>
<td>254,000</td>
<td></td>
</tr>
<tr>
<td>Net income for 1985</td>
<td>211,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities &amp; Stockholders' Equity</strong></td>
<td><strong>$ 1,375,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Income Statement**

<table>
<thead>
<tr>
<th>Dr. (Cr.)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$(1,580,000)</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>755,000</td>
</tr>
<tr>
<td>Selling &amp; administrative expenses</td>
<td>485,000</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>29,000</td>
</tr>
<tr>
<td>Estimated loss from lawsuit</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td><strong>$ (211,000)</strong></td>
</tr>
</tbody>
</table>
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.
Selected Questions

1N84

Number 5 (Estimated time — — 40 to 50 minutes)

Presented below is information pertaining to Ward Specialty Foods, a calendar-year sole proprietorship, maintaining its books on the cash basis during the year. At year-end, however, Mary Ward’s accountant adjusts the books to the accrual basis only for sales, purchases, and cost of sales, and records depreciation to more clearly reflect the business income for income tax purposes.

Ward Specialty Foods
TRIAL BALANCE
December 31, 1983

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$18,500</td>
</tr>
<tr>
<td>Accounts receivable, 12/31/82</td>
<td>4,500</td>
</tr>
<tr>
<td>Inventory, 12/31/82</td>
<td>20,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
</tr>
<tr>
<td>Accumulated depreciation, 12/31/82</td>
<td>$9,000</td>
</tr>
<tr>
<td>Accounts payable, 12/31/82</td>
<td>4,800</td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>850</td>
</tr>
<tr>
<td>Mary Ward, drawings</td>
<td>24,000</td>
</tr>
<tr>
<td>Mary Ward, capital, 12/31/82</td>
<td>33,650</td>
</tr>
<tr>
<td>Sales</td>
<td>187,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>82,700</td>
</tr>
<tr>
<td>Salaries</td>
<td>29,500</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>2,900</td>
</tr>
<tr>
<td>Rent</td>
<td>8,400</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>3,900</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,400</td>
</tr>
<tr>
<td>Utilities</td>
<td>3,500</td>
</tr>
</tbody>
</table>

$235,300 $235,300

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>12/31/82</th>
<th>12/31/83</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll taxes</td>
<td>$250</td>
</tr>
<tr>
<td>Salaries</td>
<td>375</td>
</tr>
<tr>
<td>Utilities</td>
<td>275</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>Cash Basis</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Adjustments</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Accrual Basis</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>18,500</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4,500</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allow. for doubtful accts.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>35,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accum. depreciation</td>
<td>9,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid rent</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>4,800</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>850</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ward, drawings</td>
<td>24,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ward, capital</td>
<td>33,650</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>187,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>82,700</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income summary — inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>29,500</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>2,900</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>8,400</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Miscellaneous exp.</td>
<td>3,900</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>2,400</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>3,500</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Doubtful accounts exp.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$235,300</td>
<td>$235,300</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### B. Income Statement

In November 1987 the FASB issued *Statement of Financial Accounting Standards No. 96*, "Accounting for Income Taxes." Income tax calculations in this section of *Selected Questions & Unofficial Answers* are based on *APB Opinion No. 11*, "Accounting for Income Taxes." All future examination questions and unofficial answers relating to accounting for income taxes will be based on SFAS No. 96.

**2M88**  
**Number 4 (Estimated time — — 45 to 55 minutes)**

The following information pertains to Arlon Corporation:

#### TRIAL BALANCE  
*December 31, 1987*

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$25,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>75,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>125,000</td>
<td></td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>755,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$239,000</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>70,000</td>
<td></td>
</tr>
<tr>
<td>Income tax payable</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Rental revenue received in advance</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td>55,000</td>
<td></td>
</tr>
<tr>
<td>Common stock, $.05 par</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>305,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings, 1/1/87</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Sales — regular</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Sales — Mem Division</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Proceeds from term life insurance policy</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Cost of sales — regular</td>
<td>310,000</td>
<td></td>
</tr>
<tr>
<td>Cost of sales — Mem Division</td>
<td>45,000</td>
<td></td>
</tr>
<tr>
<td>Administrative expenses — regular</td>
<td>103,000</td>
<td></td>
</tr>
<tr>
<td>Administrative expenses — Mem Division</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>Interest expense — regular</td>
<td>10,500</td>
<td></td>
</tr>
<tr>
<td>Interest expense — Mem Division</td>
<td>7,000</td>
<td></td>
</tr>
<tr>
<td>Loss on disposal of Mem Division</td>
<td>12,500</td>
<td></td>
</tr>
<tr>
<td>Gain on acquisition of bonds payable</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Income tax expense</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$1,503,000</strong></td>
<td><strong>$1,503,000</strong></td>
</tr>
</tbody>
</table>

**Selected Questions**

#### Other Information

<table>
<thead>
<tr>
<th><strong>Income tax</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid with Federal Tax Deposit Forms</td>
</tr>
<tr>
<td>Accrued</td>
</tr>
<tr>
<td>Total charged to income tax expense</td>
</tr>
</tbody>
</table>

*Does not reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.

<table>
<thead>
<tr>
<th><strong>Income per income tax return</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>$99,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Tax rate on all types of taxable income</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>22%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Timing differences</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation per financial statements — regular</td>
</tr>
<tr>
<td>Depreciation per income tax return</td>
</tr>
<tr>
<td>Rental revenue received in advance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Permanent difference</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from term life insurance policy</td>
</tr>
</tbody>
</table>

#### Discontinued operations

On June 30, 1987, Arlon sold its Mem Division for $200,000. The carrying amount of this business segment was $212,500 at that date. This sale was considered as a disposal of a segment of a business for financial statement purposes. Since there was no phaseout period, the measurement date was June 30, 1987.

**Liabilities**

On June 30, 1987, Arlon acquired $100,000 carrying amount of its long-term bonds for $87,000. All other liabilities mature in 1988.

**Capital structure**

Common stock, $.05 par, traded over-the-counter; 1,000,000 shares issued and outstanding at 1/1/87 and 12/31/87.

**Required:**

Using the multiple-step format, prepare a formal income statement for Arlon for the year ended December 31, 1987, together with supporting computations of current and deferred income taxes and of income from discontinued operations.
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>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 675,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>1,695,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>2,185,000</td>
</tr>
<tr>
<td>Property, plant and equipment (net)</td>
<td>8,660,000</td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>$ 1,895,000</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>360,000</td>
</tr>
<tr>
<td>Deferred income tax</td>
<td>285,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>2,300,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>3,675,000</td>
</tr>
<tr>
<td>Retained earnings, 1/1/85</td>
<td>3,350,000</td>
</tr>
<tr>
<td>Net sales — Regular</td>
<td>10,750,000</td>
</tr>
<tr>
<td>— Plastics Division</td>
<td>2,200,000</td>
</tr>
<tr>
<td>Cost of sales — Regular</td>
<td>5,920,000</td>
</tr>
<tr>
<td>— Plastics Division</td>
<td>1,650,000</td>
</tr>
<tr>
<td>Selling and administrative expenses — Regular</td>
<td>2,600,000</td>
</tr>
<tr>
<td>— Plastics Division</td>
<td>660,000</td>
</tr>
<tr>
<td>Interest income — Regular</td>
<td>65,000</td>
</tr>
<tr>
<td>Gain on litigation settlement — Regular</td>
<td>200,000</td>
</tr>
<tr>
<td>Depreciation adjustment from accounting change — Regular</td>
<td>350,000</td>
</tr>
<tr>
<td>Gain on disposal of Plastics Division</td>
<td>150,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>835,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$25,230,000</strong></td>
</tr>
<tr>
<td><strong>Total charged to income tax expense (estimated)</strong></td>
<td><strong>$25,230,000</strong></td>
</tr>
</tbody>
</table>

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.

AP-156
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>
</tr>
</thead>
<tbody>
<tr>
<td>200,000</td>
</tr>
<tr>
<td>30,000</td>
</tr>
<tr>
<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.

Before closing the books for the year ended December 31, 1984, Glenn Corporation, a Kansas corporation, prepared the following adjusted trial balance:

<table>
<thead>
<tr>
<th>Adjusted Trial Balance</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$550,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>1,650,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>2,750,000</td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>13,550,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$4,400,000</td>
<td></td>
</tr>
<tr>
<td>Cash surrender value on officers’ life insurance</td>
<td>65,000</td>
<td>1,550,000</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td></td>
<td>200,000</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Deferred income tax</td>
<td>1,500,000</td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td>2,500,000</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>4,375,000</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>3,300,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings, 1/1/84</td>
<td>12,500,000</td>
<td></td>
</tr>
<tr>
<td>Net sales</td>
<td>7,500,000</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>2,425,000</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>245,000</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of long-term investments</td>
<td>260,000</td>
<td></td>
</tr>
<tr>
<td>Income tax expense</td>
<td>600,000</td>
<td></td>
</tr>
<tr>
<td>Loss on litigation settlement</td>
<td>450,000</td>
<td></td>
</tr>
<tr>
<td>Loss due to earthquake damage</td>
<td>950,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$30,735,000</td>
<td><strong>$30,735,000</strong></td>
</tr>
</tbody>
</table>
Other financial data for the year ended December 31, 1984:

**Federal income tax**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated tax payments</td>
<td>$400,000</td>
</tr>
<tr>
<td>Accrued</td>
<td>$200,000</td>
</tr>
<tr>
<td><strong>Total charged to income tax expense (estimated)</strong></td>
<td><strong>$600,000</strong></td>
</tr>
</tbody>
</table>

*Does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.

**Tax rate on all types of taxable income**

- 40%

**Timing difference**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation per tax return</td>
<td>$760,000</td>
</tr>
<tr>
<td>Depreciation per books</td>
<td>$580,000</td>
</tr>
</tbody>
</table>

**Permanent difference**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums on officers’ life insurance</td>
<td>$140,000</td>
</tr>
</tbody>
</table>

**Capital structure**

<table>
<thead>
<tr>
<th>Description</th>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, par value $10 per share, traded on a national exchange:</td>
<td></td>
</tr>
<tr>
<td>Number of shares outstanding at 1/1/84</td>
<td>200,000</td>
</tr>
<tr>
<td>Number of shares issued on 3/30/84 as a 10% stock dividend</td>
<td>20,000</td>
</tr>
<tr>
<td>Number of shares sold for $25 per share on 6/30/84</td>
<td>30,000</td>
</tr>
<tr>
<td>Number of shares outstanding at 12/31/84</td>
<td>250,000</td>
</tr>
</tbody>
</table>

**Required:**

a. Using the multiple-step format, prepare a formal income statement for Glenn for the year ended December 31, 1984. All components of income tax expense should be appropriately shown.

b. Prepare a schedule to reconcile net income to taxable income reportable on Glenn's tax return for 1984.

**C. Statement of Cash Flows**

In November 1987, the FASB issued *Statement of Financial Accounting Standards No. 95, “Statement of Cash Flows.” Accordingly, all previous examination questions and unofficial answers pertaining to “Statement of Changes in Financial Position,” covered by *APB Opinion No. 19, Reporting Changes in Financial Position, have been deleted.*
E. **Consolidated Financial Statements or Worksheets**

2N67
Number 5 (Estimated time — 40 to 50 minutes)

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.
### 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>Debit</th>
<th>Credit</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>75,000</td>
<td>15,000</td>
<td></td>
<td></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>
<td></td>
<td></td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>920,000</td>
<td>670,000</td>
<td></td>
<td></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>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Sy Corp.</td>
<td>1,200,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>3,605,000</td>
<td>1,205,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Liabilities and Stockholders' Equity

| Accounts payable and other current liabilities | 140,000 | 305,000 |
| Common stock ($10 par)                        | 500,000 | 200,000 |
| Retained earnings                             | 2,965,000 | 700,000 |
| Totals                                        | 3,605,000 | 1,205,000 |

AP-160
Selected Questions

1N85
Number 5 (Estimated time — 40 to 50 minutes)


On December 31, 1984, after year-end adjustments and closing nominal accounts, the companies had condensed balance sheet accounts as follows:

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Case</th>
<th>Frey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 825,000</td>
<td>$ 330,000</td>
</tr>
<tr>
<td>Accounts and other receivables</td>
<td>2,140,000</td>
<td>835,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>2,310,000</td>
<td>1,045,000</td>
</tr>
<tr>
<td>Land</td>
<td>650,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Depreciable assets, net</td>
<td>4,575,000</td>
<td>1,980,000</td>
</tr>
<tr>
<td>Investment in Frey, Inc.</td>
<td>2,430,000</td>
<td>—</td>
</tr>
<tr>
<td>Long-term investments and other assets</td>
<td>865,000</td>
<td>385,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$13,795,000</strong></td>
<td><strong>$4,875,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders' Equity:</th>
<th>Case</th>
<th>Frey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and other current liabilities</td>
<td>$ 2,465,000</td>
<td>$ 1,145,000</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>1,900,000</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Common stock, $25 par value</td>
<td>3,200,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,850,000</td>
<td>190,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,380,000</td>
<td>1,240,000</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders' equity</strong></td>
<td><strong>$13,795,000</strong></td>
<td><strong>$4,875,000</strong></td>
</tr>
</tbody>
</table>

Additional information is as follows:

- On June 15, 1984, Frey paid a cash dividend of $4 per share on its common stock.
- On December 10, 1984, Case paid a cash dividend totaling $256,000 on its common stock.
- On June 30, 1984, immediately before the combination, the stockholders' equities were

<table>
<thead>
<tr>
<th></th>
<th>Case</th>
<th>Frey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$2,200,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,660,000</td>
<td>190,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,036,000</td>
<td>980,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$6,896,000</strong></td>
<td><strong>$2,170,000</strong></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.
### Case, Inc. and Subsidiary

**CONSOLIDATED BALANCE SHEET WORKSHEET**  
*December 31, 1984*

<table>
<thead>
<tr>
<th></th>
<th><strong>Case, Inc.</strong></th>
<th><strong>Frey, Inc.</strong></th>
<th><strong>Adjustments &amp; Eliminations</strong></th>
<th><strong>Consolidated</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td>Debit</td>
<td>Credit</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 &amp; other assets</td>
<td>865,000</td>
<td>385,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets:</strong></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Liabilities and Stockholders' Equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable &amp; other current liabilities</td>
<td>$ 2,465,000</td>
<td>$1,145,000</td>
<td></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><strong>Total Liabilities and Stockholders' Equity:</strong></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Selected Questions

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

A. Cash, Marketable Securities, and Investments

1986
Number 4 (Estimated time — 45 to 55 minutes)

On December 31, 1984, Lee, Inc., reported as long-term investments the following marketable equity securities:

Dale Corp., 5,000 shares of common stock (a 1% interest) $125,000
Ewing Corp., 10,000 shares of common stock (a 2% interest) 160,000
Fox Corp., 25,000 shares of common stock (a 10% interest) 700,000

Marketable equity securities at cost 985,000
Less valuation allowance to reduce long-term investments in marketable equity securities to market value 50,000

Marketable equity securities at market $935,000

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 $3,800,000 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>December 31,</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>

• 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>
</tbody>
</table>

(Dividend was paid 10/1/85)

• 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.

AP-163
Accounting Practice

B. Receivables and Accruals

1M88
Number 5 (Estimated time — 40 to 50 minutes)

Among the account balances of Rowe Corp. at December 31, 1986, are the following:

- Patent, net of accumulated patent amortization: $245,000
- Installment contract receivable, including current portion: 720,000

In its year-end financial statements, Rowe reports as other noncurrent assets all assets that are not classified as property, plant, and equipment or as current assets. Relevant transactions and other information for 1987 were as follows:

- The patent was purchased from Lake Co. for $315,000 on September 1, 1983. On that date the remaining legal life was 15 years, which was also determined to be the useful life.
- The installment contract receivable represents the balance of the consideration received from the sale of a factory building to Pitt Co. on March 31, 1985, for $1,200,000. Pitt made a $300,000 down payment and signed a five-year 15% note for the $900,000 balance. The first of equal annual principal payments of $180,000 was received on March 31, 1986, together with interest to that date. The note is collateralized by the factory building with a fair value of $1,000,000 at December 31, 1986, and December 31, 1987. The 1987 payment was received on time.
- On January 2, 1987, Rowe purchased a trademark from Kerr Corp. for $250,000. Rowe considers the life of the trademark to be indefinite. The trademark will be amortized over the maximum period allowable.
- On May 1, 1987, Rowe sold the patent to Strand Co. in exchange for a $500,000 noninterest bearing note due on May 1, 1990. There was no established exchange price for the patent, and the note had no ready market. The prevailing rate of interest for a note of this type at May 1, 1987 was 14%. The present value of 1 for three periods at 14% is 0.675. The collection of the note receivable from Strand is reasonably assured.
- On July 1, 1987, Rowe paid $1,880,000 for 75,000 shares of Black Corp.'s common stock, which represented a 25% investment in Black. The fair value of all of Black's identifiable assets net of liabilities equals their carrying amount of $6,400,000. Rowe has the ability to exercise significant influence over Black's operating and financial policies. Rowe amortizes goodwill over a 40-year period. The market price of Black's common stock on December 31, 1987 was $26.50 per share.
- Black reported net income and paid dividends of:

<table>
<thead>
<tr>
<th>Period</th>
<th>Income</th>
<th>Dividends per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Six months ended 6/30/87</td>
<td>$576,000</td>
<td>None</td>
</tr>
<tr>
<td>Six months ended 12/31/87</td>
<td>704,000</td>
<td>$2.00</td>
</tr>
</tbody>
</table>

(Dividend was paid 11/30/87)

- Rowe and Black had no other intercompany transactions.

Required:

a. Prepare a separate schedule of changes for each of the other noncurrent asset accounts during 1987.

b. Prepare a schedule showing the revenues, gains, and expenses relating to Rowe's other noncurrent assets for the year ended December 31, 1987.

1M84
Number 5 (Estimated time — 40 to 50 minutes)

Linden, Inc., had the following long-term receivable account balances at December 31, 1982:

- Note receivable from sale of division: $1,500,000
- Note receivable from officer: 400,000

Transactions during 1983 and other information relating to Linden's long-term receivables were as follows:

- The $1,500,000 note receivable is dated May 1, 1982, bears interest at 9%, and represents the balance of the consideration received from the sale of Linden's electronics division to Pitt Company. Principal payments of $500,000 plus appropriate interest are due on May 1, 1983, 1984, and 1985. The first principal and interest payment was made on May 1, 1983. Collection of the note installments is reasonably assured.
- The $400,000 note receivable is dated December 31, 1980, bears interest at 8%, and is due on December 31, 1985. The note is due from Robert Finley, president of Linden, Inc., and is collateralized by 10,000 shares of Linden's common stock. Interest is payable annually on December 31 and all interest payments were 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

AP-164
Selected Questions

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 $6,000. 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. 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.

D. Property, Plant, and Equipment Owned or Leased

1987 Number 4 (Estimated time — — 40 to 50 minutes)

The plant asset and accumulated depreciation accounts of Pell Corporation had the following balances at December 31, 1985:

<table>
<thead>
<tr>
<th>Planta</th>
<th>Accumulated depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 350,000</td>
</tr>
<tr>
<td>Land improvements</td>
<td>180,000</td>
</tr>
<tr>
<td>Building</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,158,000</td>
</tr>
<tr>
<td>Automobiles</td>
<td>150,000</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.
Accounting Practice

1N85
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></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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Patent</td>
<td>$192,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>(24,000)</td>
</tr>
<tr>
<td>Deferred income tax charges</td>
<td>36,000</td>
</tr>
</tbody>
</table>

Munn reports as other noncurrent assets any assets that are either intangible or not used directly in its operations.

Transactions during 1984 and other information relating to Munn's other noncurrent assets were as follows:

- The patent was purchased from Grey Company for $192,000 on January 1, 1982, at which date the remaining legal life was 16 years. On January 1, 1984, Munn determined that the useful life of the patent was only eight years from the date of acquisition.

- Deferred income taxes are provided in recognition of timing differences between financial statement and income tax reporting of rent income and warranty expense. The rent received in advance and warranty liability are appropriately considered noncurrent items.

  For the year ended December 31, 1984: (1) rent collected in advance decreased by $20,000, and (2) product warranty liability increased by $15,000. Munn's income tax rate for 1984 was 40%.

- On January 3, 1984, in connection with the purchase of a trademark from Cody Corporation, the parties entered into a non-competition agreement and a consulting contract. Munn paid Cody $800,000, of which three-quarters was for the trademark, and one-quarter was for Cody's agreement not to compete for a five-year period in the line of business covered by the trademark. Munn considers the life of the trademark to be indefinite. Under the consulting contract, Munn agreed to pay Cody $50,000 annually on January 3 for five years. The first payment was made on January 3, 1984.

- On July 1, 1984, Munn purchased as a long-term investment $1,000,000 face value of Dell Corporation original issue 8% bonds for $923,000. The bonds,
Selected Questions

which were priced to yield 10%, pay interest semi-annually 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

1M88
Number 4 (Estimated time — — 45 to 55 minutes)

Fay, Inc. finances its capital needs approximately one-third from long-term debt and two-thirds from equity. At December 31, 1986, Fay had the following liability and equity account balances:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>11% Debenture bonds payable,</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>face amount</td>
<td></td>
</tr>
<tr>
<td>Premium on bonds payable</td>
<td>352,400</td>
</tr>
<tr>
<td>Common stock</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>2,295,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,465,000</td>
</tr>
<tr>
<td>Treasury stock, at cost</td>
<td>325,000</td>
</tr>
</tbody>
</table>

Transactions during 1987 and other information relating to Fay’s liabilities and equity accounts were as follows:

- On March 2, 1987, Fay issued a 5% stock dividend on all issued shares. The market price of Fay’s common stock at time of issuance was $14 per share.
- On November 1, 1987, Fay borrowed $4,000,000 at 9%, evidenced by an unsecured note payable to United Bank. The note is payable in five equal annual principal installments of $800,000. The first principal and interest payment is due on November 1, 1988.
- On December 31, 1987, Fay owned 10,000 shares of Ryan Corp.'s common stock, which represented a 1% ownership interest. Fay accounts for this marketable equity investment as a long-term investment. The stock was purchased on May 1, 1986, at $20 per share. The market price was $21 per share on December 31, 1986, and $18 per share on December 31, 1987.
- Fay’s net income for 1987 was $2,860,000.

Required (Include formal schedules of supporting computations with each item referenced to correspond with the items in the solution):

a. Prepare the long-term liabilities section of Fay’s December 31, 1987 balance sheet, including all disclosures applicable to each obligation.

b. Prepare the stockholders’ equity section of Fay’s December 31, 1987 balance sheet.

c. Prepare a schedule showing interest expense for the year ended December 31, 1987.
Accounting Practice

1N84
Number 4 (Estimated time — — 45 to 55 minutes)

Included in Bristol Corporation’s liability account balances at December 31, 1982 were the following:

Note payable, bank $2,800,000
Liability under capital lease 430,000
Deferred income taxes 360,000

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.

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

A. Preferred and Common Stock

1N86
Number 4 (Estimated time — — 45 to 55 minutes)

Carr Corporation had the following stockholders’ equity account balances at December 31, 1984:

Preferred stock $1,800,000
Additional paid-in capital from preferred stock 90,000
Common stock 5,150,000
Additional paid-in capital from common stock 3,500,000
Retained earnings 4,000,000
Net unrealized loss on noncurrent marketable equity securities 245,000
Treasury common stock 270,000

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
Selected Questions

2M84

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</td>
<td>250,000</td>
</tr>
<tr>
<td>From sale of treasury stock</td>
<td>30,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>25,000</td>
</tr>
<tr>
<td>Allowance to reduce long-term equity securities to market</td>
<td>400,000</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>
<tr>
<td>Inventories</td>
<td>620,000</td>
</tr>
<tr>
<td>Land</td>
<td>380,000</td>
</tr>
<tr>
<td>Long-term equity securities at cost</td>
<td>310,000</td>
</tr>
<tr>
<td>Marketable equity securities at cost</td>
<td>215,000</td>
</tr>
<tr>
<td>Net unrealized loss on long-term equity securities</td>
<td>25,000</td>
</tr>
<tr>
<td>Preferred stock ($50 par value)</td>
<td>500,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>40,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>231,000</td>
</tr>
<tr>
<td>Treasury stock — common at cost</td>
<td>180,000</td>
</tr>
</tbody>
</table>

Totals $3,640,000 $3,640,000

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.

AP-169
Accounting Practice

VII. Cost Accumulation, Planning, and Control

2M88
Number 5 (Estimated time — 40 to 50 minutes)

Seco Corp., a wholesale supply company, engages independent sales agents to market the company's lines. These agents currently receive a commission of 20% of sales, but they are demanding an increase to 25% of sales made during the year ending December 31, 1989. Seco had already prepared its 1989 budget before learning of the agents' demand for an increase in commissions. The following pro forma income statement is based on this budget:

Seco Corp.

PRO FORMA INCOME STATEMENT
For the Year Ending December 31, 1989

Sales $10,000,000
Cost of sales 6,000,000
Gross margin 4,000,000

Selling and administrative costs
Commissions $2,000,000
All other costs (fixed) 100,000
2,100,000
Income before income tax 1,900,000
Income tax (30%) 570,000
Net income $ 1,330,000

Seco is considering the possibility of employing its own salespersons. Three individuals would be required, at an estimated annual salary of $30,000 each, plus commissions of 5% of sales. In addition, a sales manager would be employed at a fixed annual salary of $160,000. All other fixed costs, as well as the variable cost percentages, would remain the same as the estimates in the 1989 pro forma income statement.

Required:

a. Compute Seco's estimated breakeven point in sales dollars for the year ending December 31, 1989 based on the pro forma income statement prepared by the company.
b. Compute Seco's estimated breakeven point in sales dollars for the year ending December 31, 1989 if the company employs its own salespersons.
c. Compute the estimated volume in sales dollars that would be required for the year ending December 31, 1989 to yield the same net income as projected in the pro forma income statement, if Seco continues to use the independent sales agents and agrees to their demand for a 25% sales commission.
d. Compute the estimated volume in sales dollars that would generate an identical net income for the year ending December 31, 1989, regardless of whether Seco employs its own salespersons or continues to use the independent sales agents and pays them a 25% commission.

2N87
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

Returns in process, March 1
(25% complete) 200
Returns started in March 825
Returns in process, March 31
(80% complete) 125

Actual cost data

Returns in process March 1:
Labor $ 6,000
Overhead 2,500
Labor, March 1 to 31
4,000 hours 89,000
Overhead, March 1 to 31 45,000

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 these variances are favorable or unfavorable:

   (1) Total labor.
   (2) Labor rate.
   (3) Labor efficiency.
   (4) Total overhead.
   (5) Overhead volume.
   (6) Overhead budget.
Selected Questions

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>70,000</td>
<td>$6</td>
</tr>
<tr>
<td>80,000</td>
<td>$7</td>
</tr>
<tr>
<td>90,000</td>
<td>$8</td>
</tr>
</tbody>
</table>

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>

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

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%.

AP-171
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>Assets:</th>
<th>Book value</th>
<th>Liquidation value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$100,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>150,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$340,000</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders' Equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable — general creditors</td>
</tr>
<tr>
<td>Common stock outstanding</td>
</tr>
<tr>
<td>Deficit</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Mayne’s management informed the court that the company has developed a new product, and that a prospective customer is willing to sign a contract for the purchase of 10,000 units of this product during the year ending March 31, 1986, 12,000 units of this product during the year ending March 31, 1987, and 15,000 units of this product during the year ending March 31, 1988, at a price of $90 per unit. This product can be manufactured using Mayne’s present facilities. Monthly production with immediate delivery is expected to be uniform within each year. Receivables are expected to be collected during the calendar month following sales.

Unit production costs of the new product are expected to be as follows:

- Direct materials | $20
- Direct labor | 30
- Variable overhead | 10

Fixed costs (excluding depreciation) will amount to $130,000 per year.

Purchases of direct materials will be paid during the calendar month following purchase. Fixed costs, direct labor, and variable overhead will be paid as incurred. Inventory of direct materials will be equal to 60 days’ usage. After the first month of operations, 30 days’ usage of direct materials will be ordered each month.

The general creditors have agreed to reduce their total claims to 60% of their March 31, 1985 balances, under the following conditions:

- Existing accounts receivable and inventories are to be liquidated immediately, with the proceeds turned over to the general creditors.
- The balance of reduced accounts payable is to be paid as cash is generated from future operations, but in no event later than March 31, 1987. No interest will be paid on these obligations.

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.
Poe Corp. has manufacturing plants in Boston and Chicago. Both plants produce the same product, Xoff, which sells for $20 per unit. Budgeted revenues and costs for the year ending December 31, 1985, are:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$6,200</td>
<td>$2,200</td>
<td>$4,000</td>
</tr>
<tr>
<td>Variable factory costs:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>1,550</td>
<td>550</td>
<td>1,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,660</td>
<td>660</td>
<td>1,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>1,140</td>
<td>440</td>
<td>700</td>
</tr>
<tr>
<td>Fixed factory overhead costs</td>
<td>1,600</td>
<td>700</td>
<td>900</td>
</tr>
<tr>
<td>Fixed regional promotional costs</td>
<td>200</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Allocated home office costs</td>
<td>310</td>
<td>110</td>
<td>200</td>
</tr>
<tr>
<td>Total costs</td>
<td>6,460</td>
<td>2,560</td>
<td>3,900</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>$(260)</td>
<td>$(360)</td>
<td>$100</td>
</tr>
</tbody>
</table>

Home office costs are fixed, and are allocated to manufacturing plants on the basis of relative sales levels. Fixed regional promotional costs are discretionary advertising costs needed to obtain budgeted sales levels. Because of the budgeted operating loss, Poe is considering the possibility of ceasing operations at its Boston plant. If Poe were to cease operations at its Boston plant, proceeds from the sale of plant assets would exceed their book value and exactly cover all termination costs; fixed factory overhead costs of $50,000 would not be eliminated. Poe is considering the following three alternative plans:

- **Plan A** — Expand Boston’s operations from the budgeted 110,000 units of Xoff, to a budgeted 170,000 units. It is believed that this can be accomplished by increasing Boston’s fixed regional promotional expenditures by $120,000.

- **Plan B** — Close the Boston plant and expand Chicago’s operations from the current budgeted 200,000 units of Xoff, to 310,000 units, in order to fill Boston’s budgeted production of 110,000 units. The Boston region would continue to incur promotional costs in order to sell the 110,000 units. All sales and costs would be budgeted through the Chicago plant.

- **Plan C** — Close the Boston plant and enter into a long-term contract with a competitor to serve the Boston region’s customers. This competitor would pay Poe a royalty of $2.50 per unit of Xoff sold. Poe would continue to incur fixed regional promotional costs in order to maintain sales of 110,000 units in the Boston region.

**Required:**

a. Without considering the effects of implementing Plans A, B, and C, compute the number of units of Xoff required by the Boston plant to cover its fixed factory overhead costs and fixed regional promotional costs.

b. Prepare a schedule by plant, and in total, computing Poe’s budgeted contribution margin and operating income resulting from the implementation of each of the following plans:

1. Plan A.
2. Plan B.
3. Plan C.
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.

Number 5 (Estimated time — — 40 to 50 minutes)

At the beginning of 1984, Beal Company adopted the following standards:

<table>
<thead>
<tr>
<th>Input</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>3 lbs. @ $2.50 per lb. $ 7.50</td>
</tr>
<tr>
<td>Direct labor</td>
<td>5 hrs. @ $7.50 per hr. $37.50</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>Variable $3.00 per direct labor hour $15.00</td>
</tr>
<tr>
<td></td>
<td>Fixed   $4.00 per direct labor hour $20.00</td>
</tr>
<tr>
<td></td>
<td>Standard cost per unit $80.00</td>
</tr>
</tbody>
</table>

Normal volume per month is 40,000 standard labor hours. Beal's January 1984 budget was based on normal volume. During January Beal produced 7,800 units, with records indicating the following:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials purchased</td>
<td>25,000 lbs. @ $2.60</td>
</tr>
<tr>
<td>Direct materials used</td>
<td>23,100 lbs.</td>
</tr>
<tr>
<td>Direct labor</td>
<td>40,100 hrs. @ $7.30</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

Required:
a. Prepare a schedule of budgeted production costs for January 1984, based on actual production of 7,800 units.
b. For the month of January 1984, compute the following variances, indicating whether each is favorable or unfavorable:
   1. Direct materials price variance, based on purchases.
   2. Direct materials usage variance.
   3. Direct labor rate variance.
   4. Direct labor efficiency variance.
   5. Factory overhead spending variance.
   6. Variable factory overhead efficiency variance.
   7. Factory overhead volume variance.
Esperanza Hospital’s post-closing trial balance at December 31, 1986, appears on the tear-out worksheet.

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>Total</td>
<td>$520,000</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>Total</td>
<td>$100,000</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</td>
<td>$720,000</td>
</tr>
<tr>
<td>operations were started (estimated useful life 50</td>
<td></td>
</tr>
<tr>
<td>years), at cost</td>
<td></td>
</tr>
<tr>
<td>Installation of elevator in January 1967 (estimated</td>
<td>80,000</td>
</tr>
<tr>
<td>useful life 20 years), at cost</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

Required:

Turn to the tear-out worksheet, 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</td>
<td>Credit</td>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in U.S. Treasury bills</td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in corporate bonds</td>
<td>400,000</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></td>
<td></td>
<td></td>
<td>410,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>70,000</td>
</tr>
<tr>
<td>Endowment fund balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>520,000</td>
</tr>
<tr>
<td>Other fund balances</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,100,000</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></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Totals  | 2,120,000 | 2,120,000 |

**AP-177**
Accounting Practice

2N86

Number 4 (Estimated time — — 45 to 55 minutes)

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.
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.

AP-178
Selected Questions

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.

AP-179
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>Unrestricted</th>
<th>Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr.</td>
<td>Cr.</td>
</tr>
<tr>
<td>Cash</td>
<td>$40,000 $5,000</td>
</tr>
<tr>
<td>Bequest receivable</td>
<td>12,000</td>
</tr>
<tr>
<td>Pledges receivable</td>
<td>100,000</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>$50,000 $1,000</td>
</tr>
<tr>
<td>Investments (at cost, which approximates market)</td>
<td>2,000</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td></td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>3,000</td>
</tr>
<tr>
<td>Allowance for uncollectible pledges</td>
<td>12,000</td>
</tr>
<tr>
<td>Fund balances, July 1, 1983:</td>
<td></td>
</tr>
<tr>
<td>Designated</td>
<td>26,000</td>
</tr>
<tr>
<td>Undesignated</td>
<td>3,000</td>
</tr>
<tr>
<td>Restricted</td>
<td></td>
</tr>
<tr>
<td>Transfers of endowment fund income</td>
<td>20,000</td>
</tr>
<tr>
<td>Contributions</td>
<td>300,000</td>
</tr>
<tr>
<td>Membership dues</td>
<td>25,000</td>
</tr>
<tr>
<td>Program service fees</td>
<td>30,000</td>
</tr>
<tr>
<td>Investment income</td>
<td>10,000</td>
</tr>
<tr>
<td>Deaf children's program</td>
<td>120,000</td>
</tr>
<tr>
<td>Blind children's program</td>
<td>150,000</td>
</tr>
<tr>
<td>Management and general services</td>
<td>45,000</td>
</tr>
<tr>
<td>Fund-raising services</td>
<td>8,000</td>
</tr>
<tr>
<td>Provision for uncollectible pledges</td>
<td>2,000</td>
</tr>
</tbody>
</table>

| $478,000 | $478,000 |
|________ |________ |

**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.

Selected Questions

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:**

<table>
<thead>
<tr>
<th>Revenues and other financing sources</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes</td>
<td>$220,000</td>
</tr>
<tr>
<td>Fines, forfeits, and penalties</td>
<td>80,000</td>
</tr>
<tr>
<td>Miscellaneous revenues</td>
<td>100,000</td>
</tr>
<tr>
<td>Share of bond issue proceeds</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$600,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenditures and other financing uses</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:**

   | Program operations | $176,000 |
   | General administration | 80,000  |
   | Capital outlay     | 60,000   |
   | **Total**          | **$316,000** |

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:**

   | Delinquent taxes | $38,000 |
   | Current taxes   | 226,000 |
   | Refund of overpayment of invoice for purchase of equipment | 4,000 |
   | Fines, forfeits, and penalties | 88,000 |
   | Miscellaneous revenues | 90,000 |
   | Share of bond issue proceeds | 200,000 |
   | Transfer of remaining fund balance of a discontinued fund | 18,000 |
   | **Total**       | **$664,000** |

6. **Cancelled encumbrances:**

   | Program operations | $156,000 | $166,000 |
   | General administration | 84,000 | 80,000 |
   | Capital outlay     | 62,000   | 62,000   |
   | **Total**          | **$302,000** | **$308,000** |

AP-181
7. Additional vouchers:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program operations</td>
<td>$188,000</td>
</tr>
<tr>
<td>General administration</td>
<td>38,000</td>
</tr>
<tr>
<td>Capital outlay</td>
<td>18,000</td>
</tr>
<tr>
<td>Transfer to special assessment fund</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$264,000</strong></td>
</tr>
</tbody>
</table>

8. Albert, a taxpayer, overpaid his 1983 taxes by $2,000. He applied for a $2,000 credit against his 1984 taxes. The city council granted his request.

9. Vouchers paid amounted to $580,000.

10. Stores inventory on December 31, 1983, amounted to $12,000.

**Required:**
Prepare journal entries to record the effects of the foregoing data. Omit explanations.

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>

**Employment as part-time teacher:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross salary</td>
<td>3,000</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td></td>
</tr>
<tr>
<td>Federal income tax withheld</td>
<td>300</td>
</tr>
<tr>
<td>FICA tax withheld</td>
<td>215</td>
</tr>
</tbody>
</table>

AP-182
Selected Questions

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:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food, clothing, household, and miscellaneous personal expenses for both Ann and Earl</td>
<td>$20,000</td>
</tr>
<tr>
<td>Estimated income tax — federal</td>
<td>5,000</td>
</tr>
<tr>
<td>Estimated income tax — state</td>
<td>1,200</td>
</tr>
<tr>
<td>State inheritance tax on John's taxable estate</td>
<td>2,100</td>
</tr>
<tr>
<td>Realty taxes on residence</td>
<td>3,600</td>
</tr>
<tr>
<td>City and state sales taxes</td>
<td>1,100</td>
</tr>
<tr>
<td>Auto license and registration fees</td>
<td>50</td>
</tr>
<tr>
<td>Contribution to church</td>
<td>600</td>
</tr>
<tr>
<td>Political contribution</td>
<td>100</td>
</tr>
<tr>
<td>Lottery tickets</td>
<td>420</td>
</tr>
<tr>
<td>Pari-mutuel gambling</td>
<td>480</td>
</tr>
</tbody>
</table>

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.
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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross amount</td>
<td>$9,900</td>
</tr>
<tr>
<td>Less voluntary premiums under Medicare Part B</td>
<td>190</td>
</tr>
<tr>
<td>Net amount received</td>
<td>9,710</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross amount</td>
<td>$62,000</td>
</tr>
<tr>
<td>Amounts withheld</td>
<td></td>
</tr>
<tr>
<td>Federal income tax</td>
<td>10,000</td>
</tr>
<tr>
<td>State income tax</td>
<td>3,349</td>
</tr>
<tr>
<td>FICA taxes</td>
<td>2,792</td>
</tr>
<tr>
<td>United Fund pledge</td>
<td>240</td>
</tr>
<tr>
<td></td>
<td>16,381</td>
</tr>
<tr>
<td></td>
<td>45,619</td>
</tr>
</tbody>
</table>

- Total cash received: $64,660

**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: 100
  - Contribution to a national political party: 500
- Total cash paid: $48,600

**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.
Selected Questions

- 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.

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:

<table>
<thead>
<tr>
<th>Revenues</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$3,000,000 [1]</td>
</tr>
<tr>
<td>Equity in earnings of F &amp; W Partnership</td>
<td>60,000 [2]</td>
</tr>
<tr>
<td>Dividends</td>
<td>8,000  [3]</td>
</tr>
<tr>
<td>Interest</td>
<td>18,000 [4]</td>
</tr>
<tr>
<td>Gains on sale of stock</td>
<td>5,000  [5]</td>
</tr>
<tr>
<td>Key-man life insurance proceeds</td>
<td>100,000 [6]</td>
</tr>
<tr>
<td>Total</td>
<td>3,191,000</td>
</tr>
</tbody>
</table>

AP-185
Costs and expenses

<table>
<thead>
<tr>
<th>Item</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.
Selected Questions

2M86
Number 4 (cont.)

[3] The $8,000 dividends were from Meg, Inc., an unrelated taxable domestic corporation, whose securities are traded on a major stock exchange.

[4] Interest revenue consists of interest on:

<table>
<thead>
<tr>
<th>Type</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>

[5] 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>

[6] 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.

[7] Accounts payable for merchandise at December 31, 1984, and at December 31, 1985, amounted to $75,000 and $100,000, respectively.

[8] 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.

[9] Taxes, other than federal income, consist of:

<table>
<thead>
<tr>
<th>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>

[10] 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.

[11] Contributions were all paid in 1985 to State University, specifically designated for the purchase of laboratory equipment.

[12] Depreciation per books is straight-line. For tax purposes, depreciation amounted to $85,000. The investment tax credit amounted to $3,000.

[13] Other expenses include premiums of $5,000 on the key-man life insurance policy covering the treasurer, who died in December 1985.

[14] 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.
### Accounting Practice

**Uniform Certified Public Accountant Examination**

**Accounting Practice — Part II**

**May 1986**

**Candidate’s No.**

**State**

**Question No. 4 Page**

---

**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></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>2,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Doubtful accounts</td>
<td>13,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes, other than federal income</td>
<td>62,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>12,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>50,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal income taxes</td>
<td>120,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>2,857,000</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Net income | 334,000 |           |           |               |

---

**AP-188**
### PROBLEMS — UNOFFICIAL ANSWERS

#### I. Presentation of Financial Statements or Worksheets

**1M87**  
**Answer 5 (10 points)**

#### a. Computation of Cox’s Goodwill Implicit in the Terms of the Common Stock Issuance

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash paid by Rice for 1,000 shares</td>
<td>$86,000</td>
</tr>
<tr>
<td>Contribution by Cox</td>
<td></td>
</tr>
<tr>
<td>Current fair value of assets</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$16,500</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>20,200</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>45,000</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>1,900</td>
</tr>
<tr>
<td>Equipment</td>
<td>40,000</td>
</tr>
<tr>
<td>Total current fair value of assets</td>
<td>123,600</td>
</tr>
<tr>
<td>Current fair value of liabilities assumed</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>30,500</td>
</tr>
<tr>
<td>Note payable</td>
<td>10,000</td>
</tr>
<tr>
<td>Loan payable, delivery van</td>
<td>3,500</td>
</tr>
<tr>
<td>Interest payable</td>
<td>600</td>
</tr>
<tr>
<td>Payroll taxes withheld and accrued</td>
<td>2,100</td>
</tr>
<tr>
<td>Total current fair value of liabilities</td>
<td>46,700</td>
</tr>
</tbody>
</table>

Net contribution by Cox for 1,000 shares: $76,900  
Cox’s goodwill: $9,100

#### b. Cox Stationers, Inc.  
**BALANCE SHEET**  
**January 1, 1987**

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets:</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$23,500</td>
</tr>
<tr>
<td>Accounts</td>
<td>$23,500</td>
</tr>
<tr>
<td>Less allowance for doubtful accounts</td>
<td>3,300</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>45,000</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>1,900</td>
</tr>
<tr>
<td>Total current assets</td>
<td>169,600</td>
</tr>
<tr>
<td>Equipment</td>
<td>40,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>9,100</td>
</tr>
<tr>
<td>Total assets</td>
<td>$218,700</td>
</tr>
</tbody>
</table>
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</td>
</tr>
<tr>
<td>Payroll taxes withheld and accrued</td>
<td>2,100</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>46,700</td>
</tr>
</tbody>
</table>

**Stockholders' Equity:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $50 par; 7,500 shares; issued and outstanding 2,000 shares</td>
<td>100,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>72,000</td>
</tr>
<tr>
<td><strong>Total stockholders' equity</strong></td>
<td>172,000</td>
</tr>
</tbody>
</table>

**Total liabilities and stockholders' equity**

$218,700

**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: $3,800
   - Prepaid, 12/31/86 ($\times \frac{1}{2}$): $1,900

3. **Accrued interest on note payable**
   - Annual interest ($10,000 \times 12%): $1,200
   - July 1 — December 31, 1986 ($\times \frac{1}{2}$): $600

4. **Additional paid-in capital**
   - Total assets: $218,700
   - Deduct liabilities: 46,700
   - Total stockholders' equity: 172,000
   - Deduct common stock (2,000 shares \times $50): 100,000
   - Additional paid-in capital: $72,000
**Unofficial Answers**

**Answer 5 (10 points)**

Rand, Inc.

**WORKSHEET FOR BALANCE SHEET AND INCOME STATEMENT**

*December 31, 1985*

---

### Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Dr. (Cr.)</th>
<th>Adjustments</th>
<th>Corrected balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$275,000</td>
<td>[1] $11,000</td>
<td>$286,000</td>
</tr>
<tr>
<td>Marketable securities, at cost</td>
<td>78,000</td>
<td></td>
<td>78,000</td>
</tr>
<tr>
<td>Allowance to reduce marketable securities to market</td>
<td>—</td>
<td>[1] $11,000</td>
<td>(11,000)</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>487,000</td>
<td>[2] $15,800</td>
<td>471,200</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(50,000)</td>
<td>[3] 17,500</td>
<td>(32,500)</td>
</tr>
<tr>
<td>Inventories</td>
<td>425,000</td>
<td>[4] 30,000</td>
<td>395,000</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>310,000</td>
<td>[5] 18,500</td>
<td>328,500</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(150,000)</td>
<td>[5] 21,000</td>
<td>(129,000)</td>
</tr>
</tbody>
</table>

**Total assets:**

$1,375,000 - $66,800 - $59,000 = $1,382,800

### Liabilities & Stockholders' Equity

<table>
<thead>
<tr>
<th>Liabilities &amp; Stockholders' Equity</th>
<th>Dr. (Cr.)</th>
<th>Adjustments</th>
<th>Corrected balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable &amp; accrued liabilities</td>
<td>$420,000</td>
<td>[7] $100,000</td>
<td>$520,000</td>
</tr>
<tr>
<td>Estimated liability from lawsuit</td>
<td>—</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>Common stock</td>
<td>260,000</td>
<td></td>
<td>260,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>130,000</td>
<td></td>
<td>130,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>254,000</td>
<td>[3] 12,000</td>
<td>[4] $24,000</td>
</tr>
<tr>
<td>Balance, 1/1/85</td>
<td>211,000</td>
<td>[6] 25,000</td>
<td></td>
</tr>
</tbody>
</table>

**Total liabilities:**

$1,375,000 - $159,500 - $167,300 = $1,148,200

### Income Statement

<table>
<thead>
<tr>
<th>Income statement</th>
<th>Dr. (Cr.)</th>
<th>Dr. (Cr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$(1,580,000)</td>
<td>$(1,580,000)</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>755,000</td>
<td>[3] $5,500</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>29,000</td>
<td>[4] 6,000</td>
</tr>
<tr>
<td>Other income</td>
<td>[5] 2,500</td>
<td></td>
</tr>
<tr>
<td>Unrealized loss on marketable securities</td>
<td>[1] 11,000</td>
<td></td>
</tr>
<tr>
<td>Estimated loss from lawsuit</td>
<td>100,000</td>
<td>[7] 100,000</td>
</tr>
</tbody>
</table>

**Net income:**

$(211,000) - $47,500 - $118,300 = $(281,800)

---

AP-191
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.]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>At cost</td>
<td>$78,000</td>
</tr>
<tr>
<td>Market valuation</td>
<td>67,000</td>
</tr>
<tr>
<td>Unrealized loss on marketable securities [Dr.]</td>
<td>$11,000</td>
</tr>
<tr>
<td>Allowance to reduce marketable securities to market [Cr.]</td>
<td>$11,000</td>
</tr>
</tbody>
</table>

[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.]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Doubtful accounts expense charge at 3% of net sales for 1985</td>
<td>$47,400</td>
</tr>
<tr>
<td>Doubtful accounts expense stated at 2% of net sales for 1985</td>
<td>31,600</td>
</tr>
<tr>
<td>Allowance for doubtful accounts [Dr.]</td>
<td>$15,800</td>
</tr>
<tr>
<td>Selling &amp; adm. expense — Doubtful accounts expense [Cr.]</td>
<td>$15,800</td>
</tr>
</tbody>
</table>

[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.]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings [overstatement at 12/31/84]</td>
<td>$12,000</td>
</tr>
<tr>
<td>Cost of sales for 1985</td>
<td>5,500</td>
</tr>
<tr>
<td>Inventories [overstatement at 12/31/85]</td>
<td>$17,500</td>
</tr>
</tbody>
</table>

[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.]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property and equipment</td>
<td>$30,000</td>
</tr>
<tr>
<td>Depreciation expense — 1985</td>
<td>6,000</td>
</tr>
<tr>
<td>Accumulated depreciation [2 × $6,000]</td>
<td>$12,000</td>
</tr>
<tr>
<td>Retained earnings (understatement at 12/31/84)</td>
<td>24,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated depreciation [2 × $6,000]</td>
<td>$12,000</td>
</tr>
<tr>
<td>Retained earnings (understatement at 12/31/84)</td>
<td>24,000</td>
</tr>
</tbody>
</table>

[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.]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated depreciation</td>
<td>$21,000</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>18,500</td>
</tr>
<tr>
<td>Other income</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

[6] Incorrect recording of sales catalogs as expense in 1984
   - Selling & adm. exp. — Advertising & promotion [Dr.]
   - Retained earnings (understatement at 12/31/84) [Cr.]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling &amp; adm. exp. — Advertising &amp; promotion</td>
<td>$25,000</td>
</tr>
<tr>
<td>Retained earnings (understatement at 12/31/84)</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

[7] Reversal of liability from lawsuit — No probable loss 12/31/85
   - Estimated liability from lawsuit [Dr.]
   - Estimated loss from lawsuit [Cr.]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated liability from lawsuit</td>
<td>$100,000</td>
</tr>
<tr>
<td>Estimated loss from lawsuit</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

AP-192
a.

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></td>
<td>Dr.</td>
<td>Cr.</td>
</tr>
<tr>
<td>Cash</td>
<td>$18,500</td>
<td></td>
</tr>
<tr>
<td>Allow. for doubtful accts.</td>
<td></td>
<td></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>Accum. depreciation</td>
<td>$9,000</td>
<td>[4] 6,300</td>
</tr>
<tr>
<td>Prepaid rent</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>4,800</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>2,900</td>
<td>[8] 1,360</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></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>187,000</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>82,700</td>
<td>[7] 4,000</td>
</tr>
<tr>
<td>Income summary — inventory</td>
<td>20,000</td>
<td>[3] 20,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>29,500</td>
<td>[8] 135</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>2,900</td>
<td>[8] 150</td>
</tr>
<tr>
<td>Rent</td>
<td>8,400</td>
<td>[4] 675</td>
</tr>
<tr>
<td>Miscellaneous exp.</td>
<td>3,900</td>
<td>[5] 60</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,400</td>
<td>[6] 175</td>
</tr>
<tr>
<td>Utilities</td>
<td>3,500</td>
<td>[8] 5,800</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td>[6] 1,100</td>
</tr>
<tr>
<td>Doubtful accounts exp.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

$235,300 $235,300 $45,560 $45,560 $259,225 $259,225

Explanations of Adjustments

[2] To record provision for doubtful accounts
[3] To record increase in inventory from 12/31/82 to 12/31/83
[1] To convert 1983 sales to accrual basis

Accounts receivable, 12/31/83 $7,900
Deduct accounts receivable, 12/31/82 4,500
Increase in sales $3,400

Inventory, 12/31/83 $23,000
Inventory, 12/31/82 20,000
Increase $3,000
1N84

Answer 5 (cont.)

[4] To adjust rent expense for prepaid rent at 12/31/82 and 12/31/83

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid 12/31/83 ($8,400 x 9/12)</td>
<td>$ 6,300</td>
</tr>
<tr>
<td>Prepaid 12/31/83 ($7,500 x 9/12)</td>
<td>5,625</td>
</tr>
<tr>
<td>Rent expense decrease</td>
<td>$ 675</td>
</tr>
</tbody>
</table>

[5] To adjust insurance expense for prepaid insurance at 12/31/82 and 12/31/83

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid 12/31/83 ($2,400 x 3/12)</td>
<td>$ 600</td>
</tr>
<tr>
<td>Prepaid 12/31/83 ($2,160 x 3/12)</td>
<td>540</td>
</tr>
<tr>
<td>Insurance expense decrease</td>
<td>$ 60</td>
</tr>
</tbody>
</table>


[7] To convert 1983 purchases to accrual basis

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable 12/31/83</td>
<td>$ 8,800</td>
</tr>
<tr>
<td>Deduct accounts payable 12/31/82</td>
<td>4,800</td>
</tr>
<tr>
<td>Increase in purchases</td>
<td>$ 4,000</td>
</tr>
</tbody>
</table>

[8] To convert expenses to accrual basis

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll taxes</td>
<td>$ 400 - $250</td>
</tr>
<tr>
<td>Salaries</td>
<td>$ 510 - $375</td>
</tr>
<tr>
<td>Utilities</td>
<td>$ 450 - $275</td>
</tr>
<tr>
<td></td>
<td>$1,360</td>
</tr>
</tbody>
</table>

b. Ward Specialty Foods

STATEMENT OF CHANGES IN
MARY WARD, CAPITAL
For the Year Ended December 31, 1983

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mary Ward, capital, 12/31/82</td>
<td>$38,915</td>
</tr>
<tr>
<td>Add net income for year</td>
<td>49,475</td>
</tr>
<tr>
<td>Deduct drawings for year</td>
<td>88,390</td>
</tr>
<tr>
<td>Mary Ward, capital, 12/31/83</td>
<td>$64,390</td>
</tr>
</tbody>
</table>

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)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$190,400</td>
</tr>
<tr>
<td>Purchases</td>
<td>$86,700</td>
</tr>
<tr>
<td>Income summary-inventory</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Salaries</td>
<td>29,635</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>3,050</td>
</tr>
<tr>
<td>Rent</td>
<td>7,725</td>
</tr>
<tr>
<td>Miscellaneous expenses</td>
<td>3,900</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,340</td>
</tr>
<tr>
<td>Utilities</td>
<td>3,675</td>
</tr>
<tr>
<td>Depreciation</td>
<td>5,800</td>
</tr>
<tr>
<td>Doubtful accounts</td>
<td>1,100</td>
</tr>
<tr>
<td>Net income</td>
<td>140,925</td>
</tr>
</tbody>
</table>

Net income $ 49,475
B. Income Statement

In November 1987, the FASB issued Statement of Financial Accounting Standards No. 96, “Accounting for Income Taxes.” Income tax calculations in this section of Selected Questions & Unofficial Answers are based on APB Opinion No. 11, “Accounting for Income Taxes.” All future examination questions and unofficial answers relating to accounting for income taxes will be based on SFAS No. 96.

2M88 Answer 4 (10 points)

Arlon Corporation
INCOME STATEMENT
For the Year Ended December 31, 1987

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$500,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>310,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>190,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>103,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>87,000</td>
</tr>
<tr>
<td>Other income and expense</td>
<td></td>
</tr>
<tr>
<td>Life insurance policy proceeds</td>
<td>$10,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(10,500)</td>
</tr>
<tr>
<td>Income from continuing operations before income tax</td>
<td>86,500</td>
</tr>
<tr>
<td>Income tax</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$14,410</td>
</tr>
<tr>
<td>Deferred</td>
<td>2,420</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>16,830</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td></td>
</tr>
<tr>
<td>Income from discontinued Mem Division, less applicable income tax of $7,260</td>
<td>$25,740</td>
</tr>
<tr>
<td>Loss on disposal of Mem Division, less applicable income tax saving of $2,750</td>
<td>(9,750)</td>
</tr>
<tr>
<td>Income before extraordinary item</td>
<td>85,660</td>
</tr>
<tr>
<td>Extraordinary item — gain on acquisition of bonds payable, less applicable income tax of $2,860</td>
<td>10,140</td>
</tr>
<tr>
<td>Net income</td>
<td>$95,800</td>
</tr>
<tr>
<td>Earnings per share</td>
<td></td>
</tr>
<tr>
<td>From continuing operations</td>
<td>$.070</td>
</tr>
<tr>
<td>From discontinued operations</td>
<td>.016</td>
</tr>
<tr>
<td>Total before extraordinary item</td>
<td>.086</td>
</tr>
<tr>
<td>From extraordinary item</td>
<td>.010</td>
</tr>
<tr>
<td>Net income</td>
<td>$.096</td>
</tr>
</tbody>
</table>
Accounting Practice

2M88
Answer 4 (cont.)

COMPUTATION OF CURRENT AND DEFERRED INCOME TAXES

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations before income tax</td>
<td>$86,500</td>
</tr>
<tr>
<td>Less permanent difference — proceeds of life insurance policy</td>
<td>10,000</td>
</tr>
<tr>
<td>Balance subject to tax</td>
<td>76,500</td>
</tr>
<tr>
<td>Income tax rate</td>
<td>× 22%</td>
</tr>
<tr>
<td>Income tax on continuing operations</td>
<td>$16,830</td>
</tr>
</tbody>
</table>

**Current**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income per income tax return</td>
<td>$99,000</td>
</tr>
<tr>
<td>Less intraperiod tax allocations</td>
<td></td>
</tr>
<tr>
<td>Discontinued operations</td>
<td></td>
</tr>
<tr>
<td>Income before income tax</td>
<td>$33,000</td>
</tr>
<tr>
<td>Loss on disposal</td>
<td>(12,500)</td>
</tr>
<tr>
<td>Extraordinary item</td>
<td></td>
</tr>
<tr>
<td>Gain on acquisition of bonds payable</td>
<td></td>
</tr>
<tr>
<td>Taxable income on continuing operations</td>
<td>65,500</td>
</tr>
<tr>
<td>Income tax rate</td>
<td>× 22%</td>
</tr>
<tr>
<td>Income tax — current</td>
<td>$14,410</td>
</tr>
</tbody>
</table>

**Deferred**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation per income tax return</td>
<td>$46,000</td>
</tr>
<tr>
<td>Depreciation per financial statements</td>
<td>30,000</td>
</tr>
<tr>
<td>Excess of depreciation per income tax return over depreciation per financial statements</td>
<td>16,000</td>
</tr>
<tr>
<td>Rental revenue received in advance</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Net timing differences</td>
<td>11,000</td>
</tr>
<tr>
<td>Income tax rate</td>
<td>× 22%</td>
</tr>
<tr>
<td>Income tax — deferred</td>
<td>2,420</td>
</tr>
<tr>
<td>Income tax on continuing operations</td>
<td>$16,830</td>
</tr>
</tbody>
</table>

COMPUTATION OF INCOME FROM DISCONTINUED OPERATIONS

*For the Six Months Ended June 30, 1987 (Date of Discontinuance)*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$100,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>45,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>55,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>15,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>40,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>7,000</td>
</tr>
<tr>
<td>Income before income tax</td>
<td>33,000</td>
</tr>
<tr>
<td>Income tax (at 22%)</td>
<td>7,260</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 25,740</td>
</tr>
</tbody>
</table>

AP-196
**Garr Corporation**  
**INCOME STATEMENT**  
*For the Year Ended December 31, 1985*

<table>
<thead>
<tr>
<th>Description</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</td>
</tr>
<tr>
<td>Deferred</td>
<td>70,000</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 Plastics Division (less applicable income tax saving of $44,000)</td>
<td>(66,000) [4]</td>
</tr>
<tr>
<td>Gain on disposal of Plastics Division (less applicable income tax of $60,000)</td>
<td>90,000 [5]</td>
</tr>
<tr>
<td>Income before cumulative effect of a change in accounting principle</td>
<td>1,521,000</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>
</tbody>
</table>

**Earnings per share**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$6.51</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>0.10</td>
</tr>
<tr>
<td>Cumulative effect on prior years of changing to a different depreciation method</td>
<td>(0.91)</td>
</tr>
<tr>
<td>Net income</td>
<td>$5.70</td>
</tr>
</tbody>
</table>

**Explanations of Amounts:**

1. **Total income tax for 1985 excluding discontinued operations and cumulative effect of accounting change**

   - Income from continuing operations before income tax: $2,495,000
   - Income tax rate: $998,000

---

AP-197
Depreciation per tax return $ 750,000
Less depreciation per books $ 575,000
Timing difference 175,000
Income tax rate × 40%
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 2,310,000
Income tax saving (40% × $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% × $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 × 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 ÷ 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 ÷ 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)
Unofficial Answers

[10] Earnings per share — Net income

Net income $1,311,000
Weighted average number of shares 230,000
Earnings per share $5.70

1M85
Answer 5 (10 points)

a.

Glenn Corporation
INCOME STATEMENT
For the Year Ended December 31, 1984

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$12,500,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>7,500,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>2,425,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>2,575,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>245,000</td>
</tr>
<tr>
<td>Income before unusual or infrequent items and income tax</td>
<td>2,330,000</td>
</tr>
<tr>
<td>Unusual or infrequent items</td>
<td></td>
</tr>
<tr>
<td>Loss on litigation settlement</td>
<td>$(450,000)</td>
</tr>
<tr>
<td>Gain on sale of long-term investments</td>
<td>260,000</td>
</tr>
<tr>
<td>Income before income tax and extraordinary item</td>
<td>2,140,000</td>
</tr>
<tr>
<td>Income tax</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>840,000    [3]</td>
</tr>
<tr>
<td>Deferred</td>
<td>72,000     [2]</td>
</tr>
<tr>
<td>Income before extraordinary item</td>
<td>912,000    [1]</td>
</tr>
<tr>
<td>Extraordinary item — loss due to earthquake (net of applicable income tax saving of $380,000)</td>
<td>570,000    [4]</td>
</tr>
<tr>
<td>Net income</td>
<td>$658,000</td>
</tr>
</tbody>
</table>

Earnings per share
Income before extraordinary item $5.23 [5]
Extraordinary loss (2.43) *
Net income $2.80 [6]

*Optional

b.

Glenn Corporation
RECONCILIATION OF NET INCOME TO TAXABLE INCOME PER TAX RETURN
For the Year Ended December 31, 1984

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$658,000</td>
</tr>
<tr>
<td>Add: Income tax on income before extraordinary item</td>
<td>912,000</td>
</tr>
<tr>
<td>Permanent difference — premiums on officers’ life insurance</td>
<td>140,000</td>
</tr>
<tr>
<td></td>
<td>1,710,000</td>
</tr>
<tr>
<td>Deduct: Income tax savings — extraordinary loss</td>
<td>$380,000</td>
</tr>
<tr>
<td>Timing difference — depreciation</td>
<td>180,000</td>
</tr>
<tr>
<td></td>
<td>560,000</td>
</tr>
<tr>
<td>Taxable income per tax return</td>
<td>$1,150,000</td>
</tr>
</tbody>
</table>
Explanations of Amounts

[1] Total income tax excluding extraordinary item for 1984
   Income before income tax and extraordinary item $2,140,000
   Add permanent difference — premiums on officers’ life insurance 140,000
   Income subject to tax 2,280,000
   Income tax rate × 40%
   Income tax excluding extraordinary item $ 912,000

   Depreciation per tax return $760,000
   Less depreciation per books 580,000
   Timing difference 180,000
   Income tax rate × 40%
   Deferred income tax $ 72,000

[3] Current income tax excluding extraordinary item for 1984
   Income tax excluding extraordinary item for 1984 $912,000
   Deduct deferred income tax 72,000
   Current income tax $840,000

[4] Extraordinary item — loss due to earthquake damage
   (net of income tax) for 1984
   Loss due to earthquake damage $950,000
   Income tax saving (40% × $950,000) 380,000
   Net of income tax effect $570,000

[5] Earnings per share on income before extraordinary item for 1984
   Income before extraordinary item $1,228,000
   Weighted average number of shares outstanding for 1984
   [200,000 + 20,000 + 15,000 (½ × 30,000)] ÷ 235,000
   Earnings per share $ 5.23

[6] Earnings per share on net income for 1984
   Net income $658,000
   Weighted average number of shares ÷ 235,000
   Earnings per share $2.80

C. Statement of Cash Flows

In November 1987, the FASB issued Statement of Financial Accounting Standards No. 95, “Statement of Cash Flows.” Accordingly, all previous examination questions and unofficial answers pertaining to “Statement of Changes in Financial Position,” covered by APB Opinion No. 19, Reporting Changes in Financial Position, have been deleted.
### E. Consolidated Financial Statements or Worksheets

**2N87**  
**Answer 5 (10 points)**

#### Pym Corp. and Subsidiary  
**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></td>
<td></td>
<td></td>
<td>Debit</td>
<td>Credit</td>
</tr>
<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>[b]</td>
<td>900</td>
</tr>
<tr>
<td>Accounts &amp; other current receivables</td>
<td>410,000</td>
<td>120,000</td>
<td>[f]</td>
<td>900</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>920,000</td>
<td>670,000</td>
<td>[g]</td>
<td>5,000</td>
</tr>
<tr>
<td>Plant and equipment (net)</td>
<td>1,000,000</td>
<td>400,000</td>
<td>[h]</td>
<td>100,000</td>
</tr>
<tr>
<td>Investment in Sy Corp.</td>
<td>1,200,000</td>
<td></td>
<td>[c]</td>
<td>480,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>[c] 480,000</td>
<td>[d]</td>
<td>48,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>3,605,000</td>
<td>1,205,000</td>
<td>[e]</td>
<td>810,000</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]</td>
<td>900</td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>500,000</td>
<td>200,000</td>
<td>[g]</td>
<td>5,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,965,000</td>
<td>700,000</td>
<td>[h]</td>
<td>100,000</td>
</tr>
<tr>
<td>Minority interest, 10%</td>
<td></td>
<td>[i] 3,000</td>
<td>[e]</td>
<td>90,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>3,605,000</td>
<td>1,205,000</td>
<td>[j]</td>
<td>90,000</td>
</tr>
</tbody>
</table>
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% x 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

AP-202
# Unofficial Answers

1N85
Answer 5 (10 points)

## Case, Inc. and Subsidiary

**CONSOLIDATED BALANCE SHEET WORKSHEET**  
**December 31, 1984**

<table>
<thead>
<tr>
<th>Assets:</th>
<th></th>
<th></th>
<th>Adjustments &amp; Eliminations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Case, Inc.</td>
<td>Frey, Inc.</td>
<td>Debit</td>
</tr>
<tr>
<td>Cash</td>
<td>$825,000</td>
<td>$330,000</td>
<td>[3] $8,000</td>
</tr>
<tr>
<td>Accounts &amp; other receivables</td>
<td>2,140,000</td>
<td>835,000</td>
<td>[4] 720,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>2,310,000</td>
<td>1,045,000</td>
<td>[5] 90,000</td>
</tr>
<tr>
<td>Land</td>
<td>650,000</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>Depreciable assets, net</td>
<td>4,575,000</td>
<td>1,980,000</td>
<td></td>
</tr>
<tr>
<td>Investment in Frey, Inc.</td>
<td>2,430,000</td>
<td></td>
<td>[1] 2,430,000</td>
</tr>
<tr>
<td>Long-term investments &amp; other assets</td>
<td>865,000</td>
<td>385,000</td>
<td>[2] 320,000</td>
</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 | [2] 320,000 | 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 | $15,102,000 |

1N85
Answer 5 (cont.)

## Case, Inc. and Subsidiary

**CONSOLIDATED STATEMENT OF RETAINED EARNINGS**  
**For the Year Ended December 31, 1984**

<table>
<thead>
<tr>
<th>Explanations of Worksheet Entries &amp; Other Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>[1] To eliminate the reciprocal elements in investment and equity accounts.</td>
</tr>
<tr>
<td>[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)</td>
</tr>
</tbody>
</table>

Deduct cash dividends paid:
- By Frey, Inc., prior to combination 160,000 [7]
- By Case, Inc., after the combination 256,000 416,000

Balance, December 31, 1984  $4,290,000

AP-203
Accounting Practice

1N85
Answer 5 (cont.)


[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

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>At Cost</th>
<th>Dale</th>
<th>Ewing</th>
<th>Fox</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Date</strong></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>(700,000)</td>
<td>(700,000)</td>
</tr>
<tr>
<td>8/5/85</td>
<td></td>
<td>(16,000)</td>
<td>[1]</td>
<td>(16,000)</td>
</tr>
<tr>
<td>12/31/85</td>
<td>$125,000</td>
<td>$144,000</td>
<td>$</td>
<td>269,000</td>
</tr>
<tr>
<td><strong>At Market</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/85</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares</td>
<td>5,500</td>
<td>[2]</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Price per share</td>
<td>$23</td>
<td>$14</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$126,500</td>
<td>$140,000</td>
<td></td>
<td>266,500</td>
</tr>
</tbody>
</table>

Valuation allowance to reduce long-term investments in marketable equity securities to market value $2,500

AP-204
2.

Lee, Inc.
SCHEDULE OF LONG-TERM INVESTMENT MARKETABLE EQUITY SECURITIES CARRIED AT EQUITY
December 31, 1985

<table>
<thead>
<tr>
<th>Investment in Fox Corp., at Equity</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 [3]</td>
</tr>
<tr>
<td>Equity in earnings, 1984</td>
<td>35,000</td>
<td></td>
<td>35,000 [4]</td>
</tr>
<tr>
<td>Amortization of excess cost</td>
<td></td>
<td>(3,000)</td>
<td>(3,000) [5]</td>
</tr>
<tr>
<td>Balance, 12/31/84</td>
<td>615,000</td>
<td>117,000</td>
<td>732,000</td>
</tr>
<tr>
<td>Period 1/1/85 to 6/30/85</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity in earnings</td>
<td>20,000</td>
<td></td>
<td>20,000 [4]</td>
</tr>
<tr>
<td>Amortization of excess cost</td>
<td></td>
<td>(1,500)</td>
<td>(1,500) [5]</td>
</tr>
<tr>
<td>Balance, 6/30/85</td>
<td>635,000</td>
<td>115,500</td>
<td>750,500</td>
</tr>
<tr>
<td>20% interest, 7/1/85</td>
<td>1,270,000</td>
<td>250,000</td>
<td>1,520,000</td>
</tr>
<tr>
<td>Period 7/1/85 to 12/31/85</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity in earnings</td>
<td>111,000</td>
<td>(4,625)</td>
<td>(4,625) [5]</td>
</tr>
<tr>
<td>Amortization of excess cost</td>
<td></td>
<td>(97,500)</td>
<td>(97,500) [6]</td>
</tr>
<tr>
<td>Dividend, 10/1/85</td>
<td></td>
<td></td>
<td></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.

Lee, Inc.
SCHEDULE OF INVESTMENT INCOME
For the Year Ended December 31, 1985

<table>
<thead>
<tr>
<th>Dividends</th>
<th>$ 4,125 [7]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dale Corp., common stock</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Realized gain on sale of securities</th>
<th>$ 2,800 [8]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ewing Corp., stock rights</td>
<td></td>
</tr>
</tbody>
</table>

| Equity in earnings of Fox Corp. |             |
| Lee's 10% interest in earnings for period | $ 20,000 [4] |
| January 1 to June 30, 1985          |             |
| Lee's 30% interest in earnings for period | 111,000 [4] |
| July 1 to December 31, 1985         |             |
| Amortization of excess of cost over underlying equity | (6,125) [5] |
| Equity in earnings of Fox Corp.     | $124,875    |
Accounting Practice

1N86
Answer 4 (cont.)

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
   Rights — $1.50 per right × 10,000 rights
   Cost allocated to shares (90% × $160,000)
   Cost allocated to rights (10% × $160,000)
   Total Cost

[2] Dale common shares
   Balance, 12/31/84
   10% stock dividend, 5/1/85
   Total, 12/31/85

[3] 10% Interest, 1/2/84
   Underlying equity (10% × $5,800,000)
   Excess of cost
   Total paid for 10% interest

[4] Equity in earnings of Fox
   Year ended 12/31/84
   (10% interest × $350,000)
   Period 1/1/85 to 6/30/85
   (10% interest × $200,000)
   Period 7/1/85 to 12/31/85
   (30% interest × $370,000)

[5] Amortization of excess cost
   Year ended 12/31/84 ($120,000 ÷ 40)
   Period 1/1/85 to 6/30/85 ($3,000 × ½)
   Period 7/1/85 to 12/31/85
   10% interest
   20% interest ($250,000 ÷ 40 × ½)
   Total for year ended 12/31/85

[6] Dividends received from Fox
   10/1/85 (75,000 shares × $1.30)

[7] Dividend on Dale Corp. stock
   Shares owned
   × $0.75 per share 11/1/85
   Dividend received
Unofficial Answers

[8] Realized gain on sale of Ewing Corp. stock rights
Sales proceeds, 12/16/85
Cost allocated to rights
Realized gain

\[ \begin{align*}
&\text{Sales proceeds, 12/16/85} & \quad \$18,800 \\
&\text{Cost allocated to rights} & \quad 16,000 \quad \{1\} \\
&\text{Realized gain} & \quad 2,800
\end{align*} \]

B. Receivables and Accruals

1M88
Answer 5 (10 points)

Rowe Corp.
SCHEDULE OF CHANGES IN NOTE FROM SALE OF PATENT 1987

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face amount, 5/1/87 (due 5/1/90)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Deduct imputed interest</td>
<td>162,500</td>
</tr>
<tr>
<td>Balance, 5/1/87</td>
<td>337,500</td>
</tr>
<tr>
<td>Add interest earned to 12/31/87</td>
<td>31,500</td>
</tr>
<tr>
<td>Balance, 12/31/87, noncurrent</td>
<td>$369,000</td>
</tr>
</tbody>
</table>

Rowe Corp.
SCHEDULE OF CHANGES IN INSTALLMENT CONTRACT RECEIVABLE 1987

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 12/31/86</td>
<td>$720,000</td>
</tr>
<tr>
<td>Deduct payment, 3/31/87</td>
<td>180,000</td>
</tr>
<tr>
<td>Balance, 3/31/87 and 12/31/87</td>
<td>540,000</td>
</tr>
<tr>
<td>Deduct installment due 3/31/88</td>
<td>180,000</td>
</tr>
<tr>
<td>Balance, 12/31/87, noncurrent</td>
<td>$360,000</td>
</tr>
</tbody>
</table>

Rowe Corp.
SCHEDULE OF CHANGES IN INVESTMENT IN BLACK CORP., AT EQUITY 1987

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying equity, 25% interest, 7/1/87</td>
<td>$1,600,000 {1}</td>
</tr>
<tr>
<td>Period 7/1/87 to 12/31/87</td>
<td></td>
</tr>
<tr>
<td>Equity in earnings</td>
<td>176,000 {2}</td>
</tr>
<tr>
<td>Dividend, 11/30/87</td>
<td>(150,000) {3}</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>(3,500) {4}</td>
</tr>
<tr>
<td>Balance, 12/31/87</td>
<td>$1,626,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>$280,000</td>
</tr>
<tr>
<td>Total at equity</td>
<td>$1,880,000</td>
</tr>
<tr>
<td>Dividend, 11/30/87</td>
<td>176,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>(3,500)</td>
</tr>
</tbody>
</table>

Balance, 12/31/87
<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,626,000</td>
</tr>
<tr>
<td>$276,500</td>
</tr>
<tr>
<td>$1,902,500</td>
</tr>
</tbody>
</table>

AP-207
Rowe Corp.
SCHEDULE OF CHANGES IN PATENT
1987

<table>
<thead>
<tr>
<th>Description</th>
<th>12/31/86</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost, net of accumulated amortization, 12/31/86</td>
<td>$245,000</td>
</tr>
<tr>
<td>Deduct amortization, 1/1/87 to 5/1/87 ($315,000 ÷ 15 × 4/12)</td>
<td>(7,000)</td>
</tr>
<tr>
<td>Cost of patent sold, 5/1/87</td>
<td>238,000</td>
</tr>
<tr>
<td>Balance, 12/31/87</td>
<td>(238,000)</td>
</tr>
</tbody>
</table>

Rowe Corp.
SCHEDULE OF CHANGES IN TRADEMARK
1987

<table>
<thead>
<tr>
<th>Description</th>
<th>12/31/87</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost, 1/2/87</td>
<td>$250,000</td>
</tr>
<tr>
<td>Deduct amortization for 1987 ($250,000 ÷ 40)</td>
<td>6,250</td>
</tr>
<tr>
<td>Balance, net of accumulated amortization, 12/31/87</td>
<td>$243,750</td>
</tr>
</tbody>
</table>

**Explanations of Amounts**

- Underlying equity (25% × $6,400,000)                                     $1,600,000 [1]
- Equity in earnings (25% × $704,000)                                      $176,000 [2]
- Dividend, 11/30/87 ($2 × 75,000 shares)                                  $150,000 [3]
- Amortization of goodwill ($280,000 ÷ 40 × ½)                             $3,500 [4]

b.
Rowe Corp.
SCHEDULE OF REVENUES, GAINS, AND EXPENSES RELATING TO OTHER NONCURRENT ASSETS
For the Year Ended December 31, 1987

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
</table>
| Gain recognized on sale of patent                                         $99,500    [5]
| Interest revenue                                                          |            |
| Noninterest bearing note                                                  |            |
| Installment contract                                                      | $31,500    [Part a] |
| Total                                                                     | 76,050     |
| Total                                                                     | $107,550   |
| Equity in earnings of Black Corp.                                          | $172,500   [7]|
| Amortization expense — intangibles                                         |            |
| Patent                                                                    | $7,000     [Part a] |
| Trademark                                                                 | 6,250      [Part a] |
| Total                                                                     | $13,250    |

**Explanations of Amounts**

[5] Gain recognized on sale of patent
   - Selling price (net of imputed interest)                                $337,500 [Part a]
   - Carrying amount of patent at date of sale                              238,000 [Part a]
   - Gain recognized                                                        $99,500
[6] Interest revenue — installment contract
  Interest received 3/31/87 ($720,000 \times 13\%) \quad \$92,600
  Interest 1/1/87 to 3/31/87 \times \frac{1}{4} \quad \$ 23,400
  Interest accrued 4/1/87 to 12/31/87
    ($540,000 \times 13\% \times 9/12) \quad \$52,650
  Interest, year ended 12/31/87 \quad \$ 76,050

  Equity in Black's net income for 1987 \quad \$176,000 [2]
  Deduct amortization of goodwill \quad 3,500 [4]
  Equity in earnings of Black Corp. \quad \$172,500

1M84
Answer 5 (10 points)

1. 

$Linden, Inc.$

**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 \quad \$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 \quad 400,000

Non-interest-bearing note from sale of patent, net of 15\% imputed interest, due April 1, 1985 \quad 84,105 [2]

Installment contract receivable, due in annual installments of $50,000 to July 1, 1987, less current installment \quad 112,405 [3]

Total long-term receivables \quad \$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 \quad \$500,000 [1]
  Installment contract receivable \quad 27,600 [3]
  Total \quad \$527,600

Accrued interest receivable:
  Note receivable from sale of division \quad \$60,000 [4]
  Installment contract receivable \quad 11,200 [5]
  Total \quad \$71,200

AP-209
Linden, Inc.
INTEREST INCOME FROM LONG-TERM RECEIVABLES
AND GAINS RECOGNIZED ON SALE OF ASSETS
For the Year Ended December 31, 1983

Interest income:
Note receivable from sale of division $ 105,000 [6]
Note receivable from sale of patent 8,505 [2]
Note receivable from officer 32,000 [7]
Installment contract receivable from sale of land 11,200 [5]
Total interest income for year ended 12/31/83 $ 156,705

Gains recognized on sale of assets:
Patent $ 37,600 [8]
Land 50,000 [9]
Total gains recognized for year ended 12/31/83 $ 87,600

Explanations of Amounts
[1] Long-term Portion of 9% Note Receivable at 12/31/83
Face amount, 5/1/82 $1,500,000
Less installment received 5/1/83 500,000
Balance, 12/31/83 1,000,000
Less installment due 5/1/84 500,000
Long-term portion, 12/31/83 $ 500,000

[2] Non-interest-bearing Note, Net of Imputed Interest at 12/31/83
Face amount, 4/1/83 $ 100,000
Less imputed interest
[$100,000 — ($100,000 × 0.756)] 24,400
Balance, 4/1/83 75,600
Add interest earned to 12/31/83
($75,600 × 15% × 9/12) 8,505
Balance, 12/31/83 $ 84,105

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% × 9/12) $ 60,000

AP-210
   Interest accrued from 7/1 to 12/31/83
   \[ (140,000 \times 16\% \times \frac{1}{2}) \]
   \[ \text{\$11,200} \]

[6] Interest Income — Note Receivable, Sale of Division, for 1983
   Interest earned from 1/1 to 5/1/83
   \[ (1,500,000 \times 9\% \times \frac{4}{12}) \]
   \[ \text{\$45,000} \]
   Interest earned from 5/1 to 12/31/83
   \[ (1,000,000 \times 9\% \times \frac{8}{12}) \]
   Interest income
   \[ \text{\$105,000} \]

[7] Interest Income — Note Receivable, Officer, for 1983
   Interest earned 1/1 to 12/31/83
   \[ (400,000 \times 8\%) \]
   \[ \text{\$32,000} \]

   Stated selling price
   Less imputed interest
   Actual selling price
   Less cost of patent (net)
   Carrying value 1/1/83
   Less amortization 1/1 to 4/1/84
   \[ (8,000 \times \frac{1}{4}) \]
   Gain recognized
   \[ \text{\$37,600} \]

[9] Gain Recognized on Sale of Land
   Selling price
   Less cost
   Gain recognized
   \[ \text{\$50,000} \]
D. Property, Plant, and Equipment Owned or Leased

1N87
Answer 4 (10 points)

Pell Corporation
ANALYSIS OF CHANGES IN PLANT ASSETS
For the Year Ended December 31, 1986

<table>
<thead>
<tr>
<th></th>
<th>Balance 12/31/85</th>
<th>Increase</th>
<th>Decrease</th>
<th>Balance 12/31/86</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 350,000</td>
<td>$438,000</td>
<td>$ —</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 × $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**
b. Pell Corporation

DEPRECIATION EXPENSE
For the Year Ended December 31, 1986

Land improvements
Cost $180,000
Straight-line rate [100% ÷ 15] × 6⅔%
Total depreciation on land improvements $12,000

Building
Carrying amount 12/31/85 ($1,500,000 - $350,000) $1,150,000
150% declining balance rate ([100% ÷ 20] × 1½) × 7½%
Total depreciation on building 86,250

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%
Total depreciation on automobiles 19,000

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 4½ 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

AP-213
Blake Corporation
DEPRECIATION AND AMORTIZATION EXPENSE
For the Year Ended December 31, 1984

Building
Book value 1/1/84 ($1,200,000 - $263,100) $936,900
150% declining balance rate [(100% ÷ 25) × 1.5] × 6%
Total depreciation on building $ 56,214

Machinery and equipment
Balance, 1/1/84 $900,000
Deduct machine destroyed by fire 23,000 $877,000
Depreciation × 10% 87,700
Machine destroyed by fire, 4/1/84 $ 23,000
Depreciation from 1/1 to 4/1/84 (10% × 3/12) × 2.5% 575
Purchased 7/1/84 $310,000
Depreciation from 7/1 to 12/31/84 (10% × 6/12) × 5% 15,500
Total depreciation on machinery and equipment 103,775

Automotive equipment
Depreciation on $115,000 balance, 1/1/84 $ 18,000
Deduct depreciation on car traded in 1/2/84
(SYD 3d year 2/10 × $9,000) 1,800 16,200
Car purchased, 1/2/84 12,000
Depreciation SYD 1st year × 4/10 4,800
Total depreciation on automotive equipment 21,000

Leasehold improvements
Cost, 5/1/84 $168,000
Amortization period (5/1/84 to 12/31/90) ÷ 80 mos.
Amortization per month $ 2,100
Amortization for 1984 (5/1 to 12/31/84) × 8 mos. 16,800
Total amortization on leasehold improvements 16,800
Total depreciation and amortization expense for 1984 $197,789

1M85
Answer 4 (10 points)
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 x 10% x $23,000) 11,500
Balance, 12/31/84 $342,275

Accumulated depreciation — automotive equipment at 12/31/84
Balance, 1/1/84 $84,600
Depreciation for 1984 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 $15,500
Insurance recovery $15,500
Book value of machine destroyed
[$23,000 - (5 x 10% x $23,000)] 11,500 $4,000

Loss on car traded in on new car purchase $2,700
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
Blake Corporation
PROPERTY, PLANT, AND EQUIPMENT SECTION
OF BALANCE SHEET
December 31, 1984

<table>
<thead>
<tr>
<th>Property</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</td>
<td>342,275</td>
<td>844,725</td>
</tr>
<tr>
<td>Automotive equipment</td>
<td>118,000</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><strong>Totals</strong></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

Munn, Inc.
SCHEDULE OF EXPENSES RELATING TO OTHER NONCURRENT ASSETS
For the Year Ended December 31, 1984

<table>
<thead>
<tr>
<th>Expense</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization of intangibles</td>
<td></td>
</tr>
<tr>
<td>Patent</td>
<td>$28,000</td>
</tr>
<tr>
<td>Trademark</td>
<td>15,000</td>
</tr>
<tr>
<td>Non-competition agreement</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$83,000</td>
</tr>
<tr>
<td>Consulting fee to Cody Corporation</td>
<td>$50,000</td>
</tr>
<tr>
<td>Deferred income tax expense</td>
<td>$2,000</td>
</tr>
</tbody>
</table>
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 × 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 × 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 × 40% $ 8,000
Deduct excess of book warranty expense over tax warranty deduction of $15,000 × 40% 6,000
Net expense for 1984 $ 2,000

[5] Investment in bonds
Cost of bonds, 7/1/84 $ 923,000
Add amortization of discount from 7/1 to 12/31/84 ($46,150 – $40,000) $ 6,150
Balance, 12/31/84 $ 929,150

Cost of patent, 1/1/82 $ 192,000
Deduct accumulated amortization, 12/31/83 24,000
Patent balance, 12/31/83 $ 168,000
Deduct amortization for 1984 28,000 [1]
Balance, 12/31/84 $ 140,000
Accounting Practice

1M85
Answer 4 (cont.)

[7] Trademark, net of accumulated amortization
   Cost of trademark, 1/3/84 $ 600,000 [2]
   Deduct amortization for 1984 $ 15,000 [2]
   Balance, 12/31/84 $ 585,000

[8] Non-competition agreement, net of accumulated amortization
   Cost of non-competition agreement, 1/3/84 $ 200,000 [3]
   Deduct amortization for 1984 $ 40,000 [3]
   Balance, 12/31/84 $ 160,000

[9] Deferred income tax charges
   Balance, 12/31/83 $ 36,000
   Deduct charge to expense for 1984 $ 2,000 [4]
   Balance, 12/31/84 $ 34,000

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

1M88
Answer 4 (10 points)

a. Fay, Inc.
LONG-TERM LIABILITIES SECTION
OF BALANCE SHEET
December 31, 1987

9% unsecured note payable to bank, due in annual principal installments of $800,000, less current portion $ 3,200,000 [1]
11% debenture bonds payable due December 31, 1999, plus unamortized premium of $337,640 5,337,640 [2]
Total long-term liabilities $ 8,537,640

b. Fay, Inc.
STOCKHOLDERS' EQUITY SECTION
OF BALANCE SHEET
December 31, 1987

Common stock, $10 par; 2,000,000 shares authorized; 840,000 shares issued; 829,500 shares outstanding $ 8,400,000 [3]
Additional paid-in capital 2,485,000 [4]
Retained earnings 4,765,000 [5]
Less: net unrealized loss on noncurrent marketable equity securities $ 20,000 [6]
Treasury stock, at cost, 10,500 shares (150,000) [7]
Total stockholders' equity $15,500,000

AP-218
INTEREST EXPENSE
For the Year Ended December 31, 1987

Note payable to bank $60,000 [8]
Debenture bonds payable 535,240 [9]
Total interest expense $595,240

Explanations of Amounts

[1] 9% note payable to bank
   Note payable, 11/1/87 $4,000,000
   Deduct installment due 11/1/88 800,000
   Long-term portion, 12/31/87 3,200,000

[2] Debenture bonds payable
   Carrying amount, 12/31/86 $5,352,400
   Deduct amortization of bond premium
      Interest paid 12/31/87 ($5,000,000 × 11%) 550,000
      Less effective interest
      ($5,352,400 × 10%) 535,240
   Carrying amount, 12/31/87 5,337,640

[3] Common stock issued
   Date     Shares  Amount
   Balance  12/31/86  800,000  $8,000,000
   5% stock dividend issued 3/2/87 40,000 400,000
   Balance 12/31/87  840,000  $8,400,000

   Balance, 12/31/86 $2,295,000
   Treasury stock reissued, 1/15/87
      [$225,000 - $195,000 ($325,000 × 60%)] 30,000
   Stock dividend issued, 3/2/87
      [($14 - $10) × 40,000 shares] 160,000
   Balance, 12/31/87 2,485,000

[5] Retained earnings
   Balance, 12/31/86 $2,465,000
   Stock dividend issued, 3/2/87
      ($14 × 40,000 shares) (560,000)
   Net income for 1987 2,860,000
   Balance, 12/31/87 4,765,000

[6] Net unrealized loss on noncurrent marketable equity securities
   Balance, 12/31/87
      [(20 - 18) × 10,000 shares] 20,000

[7] Treasury stock at cost
   (10,000 ÷ 25,000 × $325,000) $130,000
Accounting Practice

Answer 4 (cont.)

[8] Interest expense on note payable to bank
   [11/1/87 to 12/31/87 ($4,000,000 × 9% × \frac{1}{12}]]
   $60,000

[9] Interest expense on debenture bonds payable
   Interest paid 12/31/87 for year ended 12/31/87
   $550,000
   Deduct amortization of bond premium for year
   $14,760
   Interest expense year ended 12/31/87
   $535,240

1N84
Answer 4 (10 points)

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

Liability under capital lease, net present value of lease payments,
less current installment
344,828

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

Deferred income taxes
396,000

Total long-term liabilities
$3,921,268

b.

Bristol Corporation
SELECTED BALANCE SHEET BALANCES
December 31, 1983

Current portion of long-term liabilities
Note payable, bank
$700,000
Liability under capital lease
45,372
Total
$745,372

Accrued interest payable
Note payable, bank
$236,250
Bonds payable
$100,000
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**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable, bank</td>
<td>$341,250</td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>60,200</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>106,440</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$507,890</strong></td>
</tr>
</tbody>
</table>

**Deferred income tax expense**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td><strong>$36,000</strong></td>
</tr>
</tbody>
</table>

**Explanations of Amounts**

1. 15% Note payable, Bank
   - Note payable, 12/31/82
   - Deduct installment paid 4/1/83
   - Balance, 12/31/83
   - Deduct current installment due 4/1/84
   - Long-term portion, 12/31/83

2. Liability under capital lease
   - Liability under capital lease, 12/31/82
   - Deduct principal portion of 12/31/83 payment
     - Lease payment
     - Less imputed interest ($430,000 × 14%)
   - Balance, 12/31/83
   - Deduct current principal payment due 12/31/84
     - Lease payment
     - Less imputed interest ($390,200 × 14%)
   - Long-term portion, 12/31/83

3. Bonds payable
   - Bonds payable issued 7/1/83
   - Add amortization of bond discount
     - Effective interest ($1,774,000 × 12% × 6/12)
     - Less accrued interest payable 12/31/83
       - ($2,000,000 × 10% × 6/12)
   - Balance, 12/31/83

4. Deferred income taxes
   - Deferred income taxes, 12/31/82
   - Add timing difference — excess of tax depreciation over book depreciation of $90,000 × 40%
   - Balance, 12/31/83

5. Accrued interest on note payable, bank
   - 4/1/83 to 12/31/83 ($2,100,000 × 15% × 9/12)
   - Balance, 12/31/83

6. Interest expense on note payable, bank
   - 1/1/83 to 3/31/83 ($2,800,000 × 15% × 3/12)
   - 4/1/83 to 12/31/83 ($2,100,000 × 15% × 9/12)
   - Interest, year ended 12/31/83
Accounting Practice

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

A. Preferred and Common Stock

1M86
Answer 4 (10 points)

a. 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 from error overstating rent income for year ended December 31, 1984 $500,000
Less income tax effect 225,000
As restated 275,000
Net income 3,725,000
Deduct dividends
Cash dividend on preferred stock 180,000 [1]
Dividend in kind on common stock 630,000 [2]
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
18,735,000
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 ($100 par \times 10\%$) \times 10
Total dividend $180,000
   Bush, Inc., common stock shares
   Market price on 2/15/85 declaration date
   \[
   \begin{array}{ccc}
   & \text{Date} & \text{Shares} & \text{Amount} \\
   \text{Balance} & 12/31/84 & 10,000 & 10,000 \\
   \text{Deduct treasury stock retired} & 1/10/85 & 30,000 & 300,000 \\
   \text{Stock rights exercised} & 4/25/85 & 210,000 & 1,050,000 \\
   \text{Employee stock options exercised} & 7/1/85 & 80,000 & 400,000 \\
   \text{Balance} & 12/31/85 & 1,030,000 & 6,630,000 \\
   \end{array}
   \]

[3] Common stock

Part b.

Chee Corporation
STOCKHOLDERS' EQUITY
December 31, 1983

Capital stock
Preferred stock, $4 cumulative, par value $50 per share;
authorized 50,000 shares, issued and outstanding 10,000 shares $ 500,000
Common stock, par value $1 per share;
authorized 500,000 shares, issued 150,000 shares, and outstanding 140,000 shares 150,000

Total capital stock 650,000

Additional paid-in capital — common
In excess of par value 1,560,000
From sale of treasury stock 250,000

Total paid-in capital 2,460,000

Retained earnings 231,000

Net unrealized loss on long-term equity securities (25,000)

Total paid-in capital and retained earnings 2,666,000
Less treasury stock, 10,000 shares at cost (180,000)

Total stockholders’ equity $2,486,000
VII. Cost Accumulation, Planning, and Control

Seco Corp.
Year Ending December 31, 1989

a. Estimated Breakeven Point Based on Pro Forma Income Statement

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>Commissions</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Contribution margin ratio</td>
<td>20%</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>$100,000</td>
</tr>
<tr>
<td>Estimated breakeven point</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

b. Estimated Breakeven Point With Company Employing Its Own Salespersons

Variable cost ratios

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>60%</td>
</tr>
<tr>
<td>Commissions</td>
<td>5%</td>
</tr>
<tr>
<td>Total</td>
<td>65%</td>
</tr>
<tr>
<td>Contribution margin ratio</td>
<td>35%</td>
</tr>
</tbody>
</table>

Fixed costs

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales manager</td>
<td>$160,000</td>
</tr>
<tr>
<td>3 salespersons @ $30,000 each</td>
<td>90,000</td>
</tr>
<tr>
<td>Administrative</td>
<td>100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$350,000</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>$350,000</td>
</tr>
<tr>
<td>Contribution margin ratio</td>
<td>35%</td>
</tr>
<tr>
<td>Estimated breakeven point</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>
c. Estimated Sales Volume Yielding Net Income
Projected in Pro Forma Income Statement
With Independent Sales Agents Receiving 25% Commission

Target income before income tax $1,900,000
Fixed costs 100,000
Total $2,000,000

Variable cost ratios
Cost of sales 60%
Commissions 25%
Total 85%

Contribution margin ratio (100% - 85%) 15%

Target income + fixed costs $2,000,000
Contribution margin ratio ÷ .15
Estimated sales volume $13,333,333

d. Estimated Sales Volume Yielding An Identical Net Income
Regardless of Whether the Company Employs its Own Salespersons
or
Continues With Independent Sales Agents and Pays Them 25% Commission

Total costs with agents receiving 25% commission = Total costs with company’s own sales force

\[ \frac{8,500,000}{10,000,000} X + 100,000 = \frac{6,500,000}{10,000,000} X + 350,000 \]

\[ .85X + 100,000 = .65X + 350,000 \]

\[ .20X = 250,000 \]

\[ X = 1,250,000 \]
a. (1) Equivalent Units

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns completed (200 + 825 - 125)</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td>Returns in process, 3/31 (125 × 80%)</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 costs</td>
<td>95,000</td>
<td>47,500</td>
</tr>
<tr>
<td>Divided by weighted average equivalent units</td>
<td>÷ 1,000</td>
<td>÷ 1,000</td>
</tr>
<tr>
<td>Actual cost per equivalent unit</td>
<td>$95.00</td>
<td>$47.50</td>
</tr>
</tbody>
</table>

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 × 80% × $95.00)</td>
<td>$ 9,500</td>
<td></td>
</tr>
<tr>
<td>Overhead (125 returns × 80% × $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. @ $20)</td>
<td>$100</td>
<td></td>
</tr>
<tr>
<td>Overhead (5 hrs. @ $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* × $100) = $6,000 favorable
(2) Labor rate variance \[\frac{[$89,000/4,000] - 20}{4,000} \times 4,000 = 9,000\] unfavorable
(3) Labor efficiency variance \[4,000 - (950* \times 5)] \times 20 = 15,000 favorable
(4) Total overhead variance (actual minus standard) $45,000 - (950* \times 50) = 2,500 favorable
(5) Overhead volume variance $49,000 - (950* \times 50) = 1,500 unfavorable
(6) Overhead budget variance $45,000 - $49,000 = 4,000 favorable

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equivalent units (weighted average method)</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Less equivalent units beginning inventory</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>(25% × 200)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equivalent units for current production</td>
<td>950</td>
<td>950</td>
</tr>
</tbody>
</table>

AP-226
**a.**

*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 \times 10\% = 7,000

[2] $70,000 \times 40\% = 28,000

[3] $70,000 \times 70\% = 49,000

80,000 \times 50\% = 40,000

80,000 \times 30\% = 24,000

80,000 \times 20\% = 16,000

90,000 \times 40\% = 36,000

90,000 \times 30\% = 27,000

90,000 \times 10\% = 9,000

---

**b. 1.**

**COMPUTATION OF CURRENT PRE-TAX ACCOUNTING RATE OF RETURN ON INVESTMENT**

Sigma Division’s current annual sales $2,000,000

Current pre-tax rate of return on sales 10% $200,000

Investment in Sigma Division 600,000

Pre-tax accounting rate of return on investment 33 1/3%

**b. 2.**

**COMPUTATION OF EXPECTED PRE-TAX ACCOUNTING RATE OF RETURN ON IMPLEMENTATION OF RECOMMENDATIONS BY MANAGER OF SIGMA DIVISION**

Sigma Division’s current annual sales $2,000,000

Expected reduction in sales volume (10%) $200,000

Expected sales volume after discontinuance of Sago $1,800,000

Expected pre-tax accounting rate of return on sales 12% $216,000

Total proposed investment in Sigma Division 700,000

Expected pre-tax accounting rate of return on investment 30.86%

**c.**

**COMPUTATION OF NET PRESENT VALUE OF INVESTMENT OPPORTUNITY ON PROPOSED LOAN TO COTE CORP.**

Discounted cash flows for year:

1. \(0.8 \times \$50,000 = \$40,000\)

2. \(0.7 \times \$90,000 = \$63,000\)

3. \(0.6 \times \$110,000 = \$66,000\)

Total $169,000

Proposed loan $200,000

Net present value $(31,000)

This investment will not earn an internal rate of return of 20%.
Mayne Manufacturing Co.
CASH BUDGET
For the Years Ending March 31,

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance of cash at beginning</td>
<td>$0</td>
<td>$75,000</td>
</tr>
<tr>
<td>Cash generated from operations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Collections from customers — Schedule A</td>
<td>$825,000</td>
<td>$1,065,000</td>
</tr>
<tr>
<td>Disbursements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct materials — Schedule B</td>
<td>220,000</td>
<td>245,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>300,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Variable overhead</td>
<td>100,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>130,000</td>
<td>130,000</td>
</tr>
<tr>
<td>Total disbursements</td>
<td>750,000</td>
<td>855,000</td>
</tr>
<tr>
<td>Excess of cash collections over cash disbursements from operations</td>
<td>75,000</td>
<td>210,000</td>
</tr>
<tr>
<td>Cash available from operations</td>
<td>75,000</td>
<td>285,000</td>
</tr>
<tr>
<td>Cash received from liquidation of existing accounts receivable and inventories</td>
<td>90,000</td>
<td>0</td>
</tr>
<tr>
<td>Total cash available</td>
<td>165,000</td>
<td>285,000</td>
</tr>
<tr>
<td>Payments to general creditors</td>
<td>90,000</td>
<td>270,000  [2]</td>
</tr>
<tr>
<td>Balance of cash at end</td>
<td>$75,000 [1]</td>
<td>$15,000 [1]</td>
</tr>
</tbody>
</table>

[1] This amount could have been used to pay general creditors or carried forward to the beginning of the next year.

[2] ($600,000 × 60%) - ($50,000 + $40,000)

Schedule A
COLLECTIONS FROM CUSTOMERS
For the Years Ending March 31,

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$900,000</td>
<td>$1,080,000</td>
</tr>
<tr>
<td>Beginning accounts receivable</td>
<td>0</td>
<td>75,000</td>
</tr>
<tr>
<td>Total</td>
<td>900,000</td>
<td>1,155,000</td>
</tr>
<tr>
<td>Less ending accounts receivable</td>
<td>75,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Collections from customers</td>
<td>$825,000</td>
<td>$1,065,000</td>
</tr>
</tbody>
</table>
**Unofficial Answers**

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</td>
<td>$200,000</td>
<td>$240,000</td>
</tr>
<tr>
<td>required for</td>
<td></td>
<td></td>
</tr>
<tr>
<td>production</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Required ending</td>
<td>40,000 [3]</td>
<td>50,000 [4]</td>
</tr>
<tr>
<td>inventory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>240,000</td>
<td>290,000</td>
</tr>
<tr>
<td>Less beginning</td>
<td>0</td>
<td>40,000</td>
</tr>
<tr>
<td>inventory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>240,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Beginning accounts</td>
<td>0</td>
<td>20,000</td>
</tr>
<tr>
<td>payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>240,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Less ending accounts</td>
<td>20,000</td>
<td>25,000</td>
</tr>
<tr>
<td>payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disbursements for</td>
<td>$220,000</td>
<td>$245,000</td>
</tr>
<tr>
<td>direct materials</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

[3] 12,000 units × \(\frac{2}{12}\) = 2,000; 2,000 × $20 per unit = $40,000

[4] 15,000 units × \(\frac{2}{12}\) = 2,500; 2,500 × $20 per unit = $50,000

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></th>
<th>Total (000 omitted)</th>
<th>Per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,200</td>
<td>$20</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>550</td>
<td>5</td>
</tr>
<tr>
<td>Direct labor</td>
<td>660</td>
<td>6</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>440</td>
<td>4</td>
</tr>
<tr>
<td>Total variable costs</td>
<td>1,650</td>
<td>15</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>$ 550</td>
<td>$ 5</td>
</tr>
</tbody>
</table>

Units required to cover fixed factory overhead and fixed regional promotional costs:

\[
\frac{($700,000 + $100,000)}{5} = 160,000 \text{ units of Xoff}
\]
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

(000 omitted)

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$7,400</td>
<td>$3,400</td>
<td>$4,000</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>1,850</td>
<td>850</td>
<td>1,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>2,020</td>
<td>1,020</td>
<td>1,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>1,380</td>
<td>680</td>
<td>700</td>
</tr>
<tr>
<td>Total variable costs</td>
<td>5,250</td>
<td>2,550</td>
<td>2,700</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>2,150</td>
<td>850</td>
<td>1,300</td>
</tr>
<tr>
<td>Fixed costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>1,600</td>
<td>700</td>
<td>900</td>
</tr>
<tr>
<td>Regional promotional</td>
<td>320</td>
<td>220</td>
<td>100</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>1,920</td>
<td>920</td>
<td>1,000</td>
</tr>
<tr>
<td>Plant operating income (loss)</td>
<td>230</td>
<td>(70)</td>
<td>300</td>
</tr>
<tr>
<td>Allocated home office costs</td>
<td>310</td>
<td>142*</td>
<td>168**</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>$(80)</td>
<td>$(212)</td>
<td>$132</td>
</tr>
</tbody>
</table>

\[
\frac{*3,400}{7,400} \times 310 = 142
\]
\[
\frac{**4,000}{7,400} \times 310 = 168
\]

b. 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

(000 omitted)

<table>
<thead>
<tr>
<th></th>
<th>Chicago Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$6,200</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>1,550</td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,550</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>1,085</td>
</tr>
<tr>
<td>Total variable costs</td>
<td>4,185</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>2,015</td>
</tr>
<tr>
<td>Fixed costs</td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>950</td>
</tr>
<tr>
<td>Regional promotional</td>
<td>200</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>1,150</td>
</tr>
<tr>
<td>Plant operating income</td>
<td>865</td>
</tr>
<tr>
<td>Allocated home office costs</td>
<td>310</td>
</tr>
<tr>
<td>Operating income</td>
<td>$ 555</td>
</tr>
</tbody>
</table>

AP-230
Unofficial Answers

Poe Corp.
SCHEDULE OF BUDGETED CONTRIBUTION MARGIN
AND OPERATING INCOME IF BOSTON PLANT IS CLOSED
AND ROYALTY AGREEMENT IS CONTRACTED (PLAN C)
For the Year Ending December 31, 1985

<table>
<thead>
<tr>
<th>Royalties (000 omitted)</th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>$4,000</td>
<td>$4,000</td>
<td></td>
</tr>
<tr>
<td>Royalties</td>
<td>275</td>
<td>$275</td>
<td></td>
</tr>
<tr>
<td>Total revenues</td>
<td>4,275</td>
<td>275</td>
<td>4,000</td>
</tr>
<tr>
<td>Variable factory costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct material</td>
<td>1,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Direct labor</td>
<td>1,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>700</td>
<td>700</td>
<td></td>
</tr>
<tr>
<td>Total variable costs</td>
<td>2,700</td>
<td>2,700</td>
<td></td>
</tr>
<tr>
<td>Contribution margin</td>
<td>1,575</td>
<td>275</td>
<td>1,300</td>
</tr>
<tr>
<td>Fixed costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td>950</td>
<td>50</td>
<td>900</td>
</tr>
<tr>
<td>Regional promotional</td>
<td>200</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>1,150</td>
<td>150</td>
<td>1,000</td>
</tr>
<tr>
<td>Plant operating income and royalty</td>
<td>425</td>
<td>125</td>
<td>300</td>
</tr>
<tr>
<td>Allocated home office costs</td>
<td>310</td>
<td></td>
<td>310</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>$ 115</td>
<td>$125</td>
<td>$(10)</td>
</tr>
</tbody>
</table>

2M84
Answer 4

1. Mat Company
SCHEDULE OF COST OF GOODS MANUFACTURED
For the Month Ended March 31, 1984

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Boston</th>
<th>Chicago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work in process — beginning inventory</td>
<td>$40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct materials</td>
<td>$104,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct labor</td>
<td>160,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Factory overhead applied</td>
<td>80,000</td>
<td>344,000</td>
<td></td>
</tr>
<tr>
<td>Production costs available</td>
<td>384,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less work in process — ending inventory</td>
<td>36,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods manufactured</td>
<td>$348,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Mat Company
SCHEDULE OF PRIME COST
For the Month Ended March 31, 1984

|                                |       |        |         |
| 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 | | |

AP-231
Accounting Practice

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>Cost Driver</th>
<th>Cost</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>
<td></td>
</tr>
<tr>
<td>Direct labor</td>
<td>7,800 units × 5 hrs. × $7.50</td>
<td>$292,500</td>
<td></td>
</tr>
<tr>
<td>Factory overhead</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>7,800 units × 5 hrs. × $3.00</td>
<td>117,000</td>
<td></td>
</tr>
<tr>
<td>Fixed</td>
<td>40,000 hrs. × $4.00</td>
<td>160,000</td>
<td></td>
</tr>
<tr>
<td>Total budgeted</td>
<td></td>
<td></td>
<td>$628,000</td>
</tr>
<tr>
<td>production costs</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

b.

1. Direct materials price variance based on materials purchased
   \[(2.60 - 2.50) \times 25,000 \text{ lbs.}\] $2,500 unfavorable

2. Direct materials usage variance
   \[\frac{23,100 \text{ lbs.} - (7,800 \text{ units} \times 3 \text{ hrs.})}{2.50}\] $750 favorable

3. Direct labor rate variance
   \[(7.30 - 7.50) \times 40,100 \text{ hrs.}\] $8,020 favorable

4. Direct labor efficiency variance
   \[\frac{40,100 \text{ hrs.} - (7,800 \text{ units} \times 5 \text{ hrs.})}{7.50}\] $8,250 unfavorable

5. Factory overhead spending variance
   Actual total factory overhead $300,000
   Budgeted total factory overhead at actual hours $280,300
   Factory overhead spending variance $19,700 unfavorable

6. Variable factory overhead efficiency variance
   Budgeted total factory overhead at actual hours $280,300
   Budgeted total factory overhead at standard hours $277,000
   Variable factory overhead efficiency variance $3,300 unfavorable

7. Factory overhead volume variance
   Budgeted total factory overhead at standard hours $277,000
   Applied total factory overhead (7,800 × 5 hrs. × $7.00) $273,000
   Factory overhead volume variance $4,000 unfavorable

AP-232
### 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 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>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>60,000</td>
<td></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>336,000</td>
<td></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>120,000</td>
<td></td>
<td></td>
<td>400,000</td>
</tr>
<tr>
<td>Other fund balances</td>
<td>1,100,000</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>
<tr>
<td>Due from general (unrestricted) funds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Due to plant replacement and expansion fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>246,000(5)</td>
</tr>
<tr>
<td>Plant replacement and expansion fund balance</td>
<td></td>
<td></td>
<td>246,000(4)</td>
<td>500,000(6)</td>
<td></td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>60,000(2)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>336,000(3)</td>
</tr>
<tr>
<td>Totals</td>
<td>2,120,000</td>
<td>2,120,000</td>
<td>2,108,000</td>
<td>2,108,000</td>
<td>1,160,000</td>
</tr>
</tbody>
</table>

**Accounting Practice**
### Esperanza Hospital

#### ADJUSTING JOURNAL ENTRIES

**January 1, 1987**

*(Not Required)*

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Endowment fund balance</strong></td>
<td></td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td></td>
</tr>
<tr>
<td><strong>To transfer investment income</strong></td>
<td></td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td></td>
</tr>
<tr>
<td><strong>To eliminate appreciation in land value</strong></td>
<td></td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td></td>
</tr>
<tr>
<td>Allowance for depreciation</td>
<td></td>
</tr>
<tr>
<td><strong>To correct allowance for depreciation account as follows:</strong></td>
<td></td>
</tr>
<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>
<tr>
<td><strong>Due from general (unrestricted) funds</strong></td>
<td></td>
</tr>
<tr>
<td>Plant replacement and expansion fund balance</td>
<td>246,000</td>
</tr>
<tr>
<td>Adjusted allowance for depreciation</td>
<td>$746,000</td>
</tr>
<tr>
<td>Investment in corporate bonds</td>
<td>500,000</td>
</tr>
<tr>
<td>Underfunded for asset replacement</td>
<td>$246,000</td>
</tr>
<tr>
<td><strong>General (unrestricted) funds balance</strong></td>
<td></td>
</tr>
<tr>
<td>Due to plant replacement and expansion fund</td>
<td>246,000</td>
</tr>
<tr>
<td><strong>Other fund balances</strong></td>
<td></td>
</tr>
<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
Pine City
SPECIAL ASSESSMENT FUND
JOURNAL ENTRIES
For the Year Ended December 31, 1985

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2</td>
<td>Estimated revenues control $4,200,000 [A] Estimated other financing sources control $10,000,000</td>
<td>$6,030,000 [B]</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Appropriations control</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Budgetary fund balance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January 2</td>
<td>Encumbrances control $9,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fund balance reserved for encumbrances $9,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January 2</td>
<td>Cash $10,000,000</td>
<td></td>
<td>$10,000,000</td>
</tr>
<tr>
<td></td>
<td>Other financing sources control</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January 2</td>
<td>Special assessments receivable — current $3,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Special assessments receivable — deferred $6,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenues control</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deferred revenues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January 2</td>
<td>Investments $8,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>$8,000,000</td>
<td></td>
</tr>
<tr>
<td>January 15</td>
<td>Expenditures control $1,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>$1,500,000</td>
</tr>
<tr>
<td></td>
<td>Fund balance reserved for encumbrances $1,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Encumbrances control $1,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>June 30</td>
<td>Cash $3,000,000</td>
<td></td>
<td>$3,000,000</td>
</tr>
<tr>
<td></td>
<td>Special assessments receivable — current $3,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>June 30</td>
<td>Cash $8,480,000</td>
<td>$8,000,000</td>
<td>$480,000</td>
</tr>
<tr>
<td></td>
<td>Investments</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Revenues control</td>
<td></td>
<td></td>
</tr>
<tr>
<td>July 1</td>
<td>Investments $11,000,000</td>
<td></td>
<td>$11,000,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>November 30</td>
<td>Expenditures control $2,100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Vouchers payable $2,100,000</td>
<td></td>
<td>$2,100,000</td>
</tr>
<tr>
<td></td>
<td>Fund balance reserved for encumbrances $2,100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Encumbrances control $2,100,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
11. **December 31**
   - Cash 11,500,000
   - Investments 11,000,000
   - Revenues control 500,000

12. **December 31**
   - Vouchers payable $2,100,000
   - Cash $2,100,000

13. **December 31**
   - Expenditures control 50,000
   - Cash 50,000

14. **December 31**
   - Expenditures control 2,120,000
   - Cash 2,120,000

15. **December 31**
   - Expenditures control 610,000
   - Interest payable [C] 610,000
   - Revenues control 300,000

[A] Special assessment revenue $3,000,000
   - Interest on deferred special assessment revenue:
     - $6,000,000 × 10% × ½ 300,000
   - Interest on certificates of deposit 900,000
   - Total 4,200,000

[B] Payments to contractor:
   - In advance $1,500,000
     - $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
   - Total 6,030,000

[C] $3,000,000 × 7% 210,000
   - 5,000,000 × 8% 400,000
   - Total 610,000

---

AP-237
### Local government

**[1] General fund**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditures control</td>
<td>$25,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
</tbody>
</table>

**General fixed assets account group**

<table>
<thead>
<tr>
<th>Equipment</th>
<th>25,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in general fixed assets from general fund revenues</td>
<td>25,000</td>
</tr>
</tbody>
</table>

**[2] General fund**

<table>
<thead>
<tr>
<th>Cash</th>
<th>Revenues control</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>100,000</td>
</tr>
</tbody>
</table>

**[3] Nonexpendable trust (endowment) fund**

<table>
<thead>
<tr>
<th>Cash</th>
<th>Operating revenues control</th>
<th>Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>55,000</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>50,000</td>
<td></td>
</tr>
</tbody>
</table>

**[4] Capital projects fund**

<table>
<thead>
<tr>
<th>Cash</th>
<th>Other financing sources control</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenditures control</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

**General long-term debt account group**

<table>
<thead>
<tr>
<th>Amount to be provided for retirement of general long-term debt</th>
<th>General obligation bonds payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

**General fixed assets account group**

<table>
<thead>
<tr>
<th>Buildings</th>
<th>Investment in general fixed assets from capital projects funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,000,000</td>
<td></td>
</tr>
</tbody>
</table>

---

AP-238
b. **Voluntary health and welfare organization**

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>[1]</td>
<td><strong>Current unrestricted fund</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fund balance — undesignated Cash</td>
<td>$ 25,000</td>
</tr>
<tr>
<td></td>
<td>Plant fund</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equipment Fund balance — expended</td>
<td>25,000</td>
</tr>
<tr>
<td>[2]</td>
<td><strong>Current unrestricted fund</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash Contributions</td>
<td>100,000</td>
</tr>
<tr>
<td>[3]</td>
<td><strong>Endowment fund</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash Due to current unrestricted fund (or investment income) Investments</td>
<td>55,000</td>
</tr>
<tr>
<td>[4]</td>
<td><strong>Plant fund</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash Bonds payable</td>
<td>1,000,000</td>
</tr>
<tr>
<td></td>
<td>Buildings Cash</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>
a.  

**Community Association for Handicapped Children**  
**STATEMENT OF SUPPORT, REVENUE, AND EXPENSES**  
**AND CHANGES IN FUND BALANCES**  
**FOR CURRENT FUNDS**  
**Year Ended June 30, 1984**

<table>
<thead>
<tr>
<th>Description</th>
<th>Unrestricted</th>
<th>Restricted</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public support and revenue</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Public support</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions (net of provision for uncollectible unrestricted pledges of $2,000)</td>
<td>$298,000</td>
<td>$15,000</td>
<td>$313,000</td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Membership dues</td>
<td>25,000</td>
<td>—</td>
<td>25,000</td>
</tr>
<tr>
<td>Program service fees</td>
<td>30,000</td>
<td>—</td>
<td>30,000</td>
</tr>
<tr>
<td>Investment income</td>
<td>10,000</td>
<td>—</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
<td>65,000</td>
<td>—</td>
<td>65,000</td>
</tr>
<tr>
<td><strong>Total public support and revenue</strong></td>
<td>363,000</td>
<td>15,000</td>
<td>378,000</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Program services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Blind children</td>
<td>150,000</td>
<td>—</td>
<td>150,000</td>
</tr>
<tr>
<td>Deaf children</td>
<td>120,000</td>
<td>—</td>
<td>120,000</td>
</tr>
<tr>
<td><strong>Total program services</strong></td>
<td>270,000</td>
<td>—</td>
<td>270,000</td>
</tr>
<tr>
<td>Supporting services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management and general</td>
<td>45,000</td>
<td>4,000</td>
<td>49,000</td>
</tr>
<tr>
<td>Fund-raising</td>
<td>8,000</td>
<td>1,000</td>
<td>9,000</td>
</tr>
<tr>
<td><strong>Total supporting services</strong></td>
<td>53,000</td>
<td>5,000</td>
<td>58,000</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td>323,000</td>
<td>5,000</td>
<td>328,000</td>
</tr>
<tr>
<td><strong>Excess of public support and revenue over expenses</strong></td>
<td>40,000</td>
<td>10,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Other changes in fund balances</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transfers of endowment fund income</td>
<td>20,000</td>
<td>—</td>
<td>20,000</td>
</tr>
<tr>
<td>Fund balances, July 1, 1983</td>
<td>38,000</td>
<td>3,000</td>
<td>41,000</td>
</tr>
<tr>
<td><strong>Fund balances, June 30, 1984</strong></td>
<td>$98,000</td>
<td>$13,000</td>
<td>$111,000</td>
</tr>
</tbody>
</table>

AP-240
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><strong>Unrestricted</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Investments (at cost, which approximates market)</td>
<td>100,000</td>
</tr>
<tr>
<td>Pledges receivable (less allowances for uncollectibles of $3,000)</td>
<td>9,000</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$150,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Fund Balances</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>2,000</td>
</tr>
<tr>
<td>Total liabilities and deferred revenue</td>
<td>52,000</td>
</tr>
<tr>
<td>Fund balances</td>
<td></td>
</tr>
<tr>
<td>Designated</td>
<td>12,000</td>
</tr>
<tr>
<td>Undesignated</td>
<td>86,000</td>
</tr>
<tr>
<td>Total fund balances</td>
<td>98,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$150,000</strong></td>
</tr>
</tbody>
</table>

| **Restricted** | | |
| Cash | $ 9,000 | |
| Bequest receivable | 5,000 | |
| **Total** | **$14,000** | |

<table>
<thead>
<tr>
<th>Funds Payable and Fund Balances</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Fund balance</td>
<td>13,000</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>1. Estimated revenues — taxes</td>
<td>$220,000</td>
</tr>
<tr>
<td>Estimated revenues — fines, forfeits, and penalties</td>
<td>80,000</td>
</tr>
<tr>
<td>Estimated revenues — miscellaneous</td>
<td>100,000</td>
</tr>
<tr>
<td>Estimated other financing sources — proceeds of bond issue</td>
<td>200,000</td>
</tr>
<tr>
<td>Appropriations — program operations</td>
<td>$360,000</td>
</tr>
<tr>
<td>Appropriations — general administration</td>
<td>120,000</td>
</tr>
<tr>
<td>Appropriations — capital outlays</td>
<td>80,000</td>
</tr>
<tr>
<td>Appropriations — other financing uses — operating transfers out to special assessment fund</td>
<td>20,000</td>
</tr>
<tr>
<td>Unreserved undesignated fund balance</td>
<td>20,000</td>
</tr>
<tr>
<td>Encumbrances — prior year</td>
<td>12,000</td>
</tr>
<tr>
<td>Appropriations — prior year</td>
<td>12,000</td>
</tr>
</tbody>
</table>

AP-241
### Accounting Practice

**Answer 4 (cont.)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Taxes receivable — current</td>
<td>230,000</td>
</tr>
<tr>
<td>Estimated uncollectible taxes — current</td>
<td>9,200</td>
</tr>
<tr>
<td>Revenues — taxes</td>
<td>$220,800</td>
</tr>
<tr>
<td>3. Encumbrances — current year</td>
<td>316,000</td>
</tr>
<tr>
<td>Fund balance reserved for encumbrances</td>
<td>316,000</td>
</tr>
<tr>
<td>4. Unreserved undesignated fund balance</td>
<td>20,000</td>
</tr>
<tr>
<td>Fund balance designated for capital outlays</td>
<td>20,000</td>
</tr>
<tr>
<td>5. Cash</td>
<td>664,000</td>
</tr>
<tr>
<td>Taxes receivable — delinquent</td>
<td>38,000</td>
</tr>
<tr>
<td>Taxes receivable — current</td>
<td>226,000</td>
</tr>
<tr>
<td>Expenditures — capital outlays</td>
<td>4,000</td>
</tr>
<tr>
<td>Revenues — fines, forfeits, and penalties</td>
<td>88,000</td>
</tr>
<tr>
<td>Revenues — miscellaneous</td>
<td>90,000</td>
</tr>
<tr>
<td>Other financing sources — proceeds of bond issue</td>
<td>200,000</td>
</tr>
<tr>
<td>Unreserved undesignated fund balance</td>
<td>18,000</td>
</tr>
<tr>
<td>6. Fund balance reserved for encumbrances</td>
<td>302,000</td>
</tr>
<tr>
<td>Encumbrances — prior year</td>
<td>12,000</td>
</tr>
<tr>
<td>Encumbrances — current year</td>
<td>290,000</td>
</tr>
<tr>
<td>Expenditures — program operations</td>
<td>166,000</td>
</tr>
<tr>
<td>Expenditures — general administration</td>
<td>80,000</td>
</tr>
<tr>
<td>Expenditures — capital outlays</td>
<td>62,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>308,000</td>
</tr>
<tr>
<td>7. Expenditures — program operations</td>
<td>188,000</td>
</tr>
<tr>
<td>Expenditures — general administration</td>
<td>38,000</td>
</tr>
<tr>
<td>Expenditures — capital outlay</td>
<td>18,000</td>
</tr>
<tr>
<td>Other financing uses — operating transfer out to special assessment fund</td>
<td>20,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>244,000</td>
</tr>
<tr>
<td>Due to special assessment fund</td>
<td>20,000</td>
</tr>
<tr>
<td>8. Taxes receivable — current</td>
<td>2,000</td>
</tr>
<tr>
<td>Deferred revenue — taxes</td>
<td>2,000</td>
</tr>
<tr>
<td>Estimated uncollectible taxes — current</td>
<td>3,200</td>
</tr>
<tr>
<td>Revenues — taxes</td>
<td>3,200</td>
</tr>
<tr>
<td>9. Vouchers payable</td>
<td>580,000</td>
</tr>
<tr>
<td>Cash</td>
<td>580,000</td>
</tr>
<tr>
<td>10. Fund balance reserved for stores inventory</td>
<td>6,000</td>
</tr>
<tr>
<td>Stores inventory — program operations</td>
<td>6,000</td>
</tr>
</tbody>
</table>
Unofficial Answers

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>Description</th>
<th>Receipts</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal income tax ($9,000 + $300 + $5,000)</td>
<td></td>
<td>$14,300</td>
</tr>
<tr>
<td>FICA tax ($3,132 + $215)</td>
<td></td>
<td>3,347</td>
</tr>
<tr>
<td>Bequest under husband’s will</td>
<td></td>
<td>$25,000</td>
</tr>
<tr>
<td>Life insurance proceeds on husband’s death</td>
<td></td>
<td>15,000</td>
</tr>
<tr>
<td>Food, clothing, household, and miscellaneous</td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>State inheritance tax</td>
<td></td>
<td>2,100</td>
</tr>
<tr>
<td>City and state sales taxes</td>
<td></td>
<td>1,100</td>
</tr>
<tr>
<td>Auto license and registration</td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>Political contribution</td>
<td></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 x 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-243
Alex and Myra Cole  
**TAXABLE INCOME**  
*For the Year Ended December 31, 1985*

### Income

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$62,000</td>
</tr>
<tr>
<td>Nonmonetary remuneration (watch)</td>
<td>$1,500</td>
</tr>
<tr>
<td>Dividends</td>
<td></td>
</tr>
<tr>
<td>Gross amount</td>
<td>$500</td>
</tr>
<tr>
<td>Exclusion</td>
<td>$200</td>
</tr>
<tr>
<td>Refund of state income tax</td>
<td>$300</td>
</tr>
<tr>
<td>Capital gain (loss)</td>
<td></td>
</tr>
<tr>
<td>Long-term ($3,000 minus $2,000)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Short-term ($700 minus $900)</td>
<td>$(200)</td>
</tr>
<tr>
<td>Excess of long-term capital gain</td>
<td></td>
</tr>
<tr>
<td>over short-term capital loss</td>
<td>$800</td>
</tr>
<tr>
<td>Taxable portion</td>
<td>40%</td>
</tr>
<tr>
<td>Social security benefits</td>
<td></td>
</tr>
<tr>
<td>Gross amount</td>
<td>$9,900</td>
</tr>
<tr>
<td>Taxable portion</td>
<td>50%</td>
</tr>
</tbody>
</table>

### Total Income

69,180

### Adjustments to Income

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee business expenses (travel)</td>
<td>$800</td>
</tr>
</tbody>
</table>

### Adjusted Gross Income

68,380

### Itemized Deductions

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical and dental expenses</td>
<td></td>
</tr>
<tr>
<td>Doctors</td>
<td>$3,000</td>
</tr>
<tr>
<td>Dentures</td>
<td>$800</td>
</tr>
<tr>
<td>Travel to doctors</td>
<td>$100</td>
</tr>
<tr>
<td>Medicare premiums</td>
<td>$190</td>
</tr>
<tr>
<td>Total</td>
<td>$4,090</td>
</tr>
<tr>
<td>Less: 5% of $68,380</td>
<td>$3,419</td>
</tr>
<tr>
<td>Taxes</td>
<td></td>
</tr>
<tr>
<td>State income tax</td>
<td>$3,349</td>
</tr>
<tr>
<td>Sales taxes</td>
<td>$1,100</td>
</tr>
<tr>
<td>Contributions</td>
<td></td>
</tr>
<tr>
<td>United Fund</td>
<td>$240</td>
</tr>
<tr>
<td>Other recognized charitable organizations</td>
<td>$7,000</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td></td>
</tr>
<tr>
<td>Employee business expenses (education)</td>
<td>$400</td>
</tr>
<tr>
<td><strong>Total Itemized Deductions</strong></td>
<td>$12,760</td>
</tr>
<tr>
<td>Less: Zero bracket amount</td>
<td>$3,540</td>
</tr>
<tr>
<td><strong>Excess of AGI over net itemized deductions</strong></td>
<td>$9,200</td>
</tr>
</tbody>
</table>

### Exemptions

<table>
<thead>
<tr>
<th>Name</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alex</td>
<td>2</td>
</tr>
<tr>
<td>Myra</td>
<td>1</td>
</tr>
<tr>
<td>Ben</td>
<td>$4 \times $1,040</td>
</tr>
</tbody>
</table>

### Taxable Income

$55,000
b. Alex and Myra Cole

**COMPUTATION OF FEDERAL INCOME TAX OVERPAYMENT**
*For the Year Ended December 31, 1985*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax before credit and payments on account</td>
<td>$12,957</td>
</tr>
<tr>
<td>Political contributions credit</td>
<td>100</td>
</tr>
<tr>
<td><strong>Net tax</strong></td>
<td>12,857</td>
</tr>
<tr>
<td>Payments on account</td>
<td></td>
</tr>
<tr>
<td>Tax withheld</td>
<td>$10,000</td>
</tr>
<tr>
<td>Estimated tax</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Total Payments on account</strong></td>
<td>13,000</td>
</tr>
<tr>
<td>Amount overpaid</td>
<td>$143</td>
</tr>
</tbody>
</table>
**WORKSHEET TO CONVERT BOOK INCOME TO TAXABLE INCOME**

*For the Year Ended December 31, 1985*

<table>
<thead>
<tr>
<th></th>
<th>Per books and GAAP</th>
<th>Increases</th>
<th>Decreases</th>
<th>Per tax return</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<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></td>
<td>58,000</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></td>
<td>15,000</td>
</tr>
<tr>
<td>Gains on sale of stock</td>
<td>5,000</td>
<td></td>
<td></td>
<td>5,000</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></td>
<td>(5,000)</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>3,191,000</td>
<td>13,000</td>
<td>128,300</td>
<td>3,075,700</td>
</tr>
<tr>
<td><strong>Costs and expenses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>2,000,000</td>
<td></td>
<td></td>
<td>2,000,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>500,000</td>
<td></td>
<td></td>
<td>500,000</td>
</tr>
<tr>
<td>Doubtful accounts</td>
<td>13,000</td>
<td></td>
<td></td>
<td>13,000</td>
</tr>
<tr>
<td>Taxes, other than federal income</td>
<td>62,000</td>
<td>2,000 [g]</td>
<td></td>
<td>60,000</td>
</tr>
<tr>
<td>Interest</td>
<td>12,000</td>
<td>1,000 [h]</td>
<td></td>
<td>11,000</td>
</tr>
<tr>
<td>Contributions</td>
<td>50,000</td>
<td>11,300 [i]</td>
<td></td>
<td>38,700</td>
</tr>
<tr>
<td>Depreciation</td>
<td>60,000</td>
<td>25,000</td>
<td></td>
<td>85,000</td>
</tr>
<tr>
<td>Other</td>
<td>40,000</td>
<td>5,000 [j]</td>
<td></td>
<td>35,000</td>
</tr>
<tr>
<td>Federal income taxes</td>
<td>120,000</td>
<td>120,000 [k]</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>2,857,000</td>
<td>25,000</td>
<td>139,300</td>
<td>2,742,700</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>334,000</td>
<td>(12,000)</td>
<td>(11,000)</td>
<td>333,000</td>
</tr>
</tbody>
</table>
Explanation of adjustments to convert book income to taxable income:

[a] Decrease in equity in earnings of F & W Partnership:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends qualifying for exclusion</td>
<td>$10,000</td>
</tr>
<tr>
<td>Less net long-term capital loss</td>
<td>(8,000)</td>
</tr>
<tr>
<td><strong>Decrease</strong></td>
<td><strong>$ 2,000</strong></td>
</tr>
</tbody>
</table>

[f] Dividends-received deduction:

\[
$10,000 \times .85 = $8,500
\]

[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:

\[
\text{Taxable income before contributions} = \text{Revenues} - \text{Deductions} + \text{Balance} + \text{Plus dividends-received deductions} = 387,000
\]

\[
\text{10% allowable deduction} = 38,700
\]

\[
\text{Actual contributions} = 50,000
\]

\[
\text{Excess not deductible in current year} = 11,300
\]

[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

Selected Questions
And Unofficial Answers
Indexed To
Content Specification Outline
TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Selected Questions</th>
<th>Pages</th>
<th>Multiple Choice Items</th>
<th>Essays</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Authority of Pronouncements (substantial authoritative support - GAAP)</td>
<td>T-1</td>
<td></td>
<td>T-51†</td>
</tr>
<tr>
<td>B. Conceptual Framework</td>
<td>T-1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Basic Concepts and Accounting Principles</td>
<td>T-2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Nature and Purpose of Basic Financial Statements</td>
<td>T-2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Consolidated Financial Statements</td>
<td>T-2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts</td>
<td>T-3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles</td>
<td>T-4</td>
<td>T-52†</td>
<td></td>
</tr>
<tr>
<td>A. Cash, Marketable Securities, and Investments</td>
<td>T-4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Receivables and Accruals</td>
<td>T-5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Inventories</td>
<td>T-6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Property, Plant, and Equipment Owned or Leased</td>
<td>T-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Intangibles and Other Assets</td>
<td>T-10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles</td>
<td>T-12</td>
<td>T-56†</td>
<td></td>
</tr>
<tr>
<td>A. Payables and Accruals</td>
<td>T-12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Deferred Revenues</td>
<td>T-13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Deferred Income Tax Liabilities</td>
<td>T-13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Capitalized Lease Liability</td>
<td>T-14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Bonds Payable</td>
<td>T-15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Contingent Liabilities and Commitments</td>
<td>T-15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles</td>
<td>T-16</td>
<td>T-59†</td>
<td></td>
</tr>
<tr>
<td>A. Preferred and Common Stock</td>
<td>T-16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Additional Paid-in Capital</td>
<td>T-16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Retained Earnings and Dividends</td>
<td>T-16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Treasury Stock and Other Contra Accounts</td>
<td>T-18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Stock Options, Warrants, and Rights</td>
<td>T-19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Reorganization and Change in Entity</td>
<td>T-19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>G. Partnerships</td>
<td>T-19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles</td>
<td>T-20</td>
<td>T-59†</td>
<td></td>
</tr>
<tr>
<td>A. Revenues and Gains</td>
<td>T-20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Expenses and Losses</td>
<td>T-22</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* No multiple choice items/essays were indexed for this group.
† Questions in this area are not classified according to group.
Selected Questions

C. Provision for Income Tax
D. Recurring Versus Nonrecurring Transactions and Events
E. Accounting Changes
F. Earnings Per Share

VI. Other Financial Topics

A. Statement of Cash Flows
B. Accounting Policies
C. Accounting Changes
D. Nonmonetary Transactions
E. Business Combinations
F. Interim Financial Statements
G. Gain Contingencies
H. Segments and Lines of Business
I. Employee Benefits
J. Analysis of Financial Statements
K. Development Stage Enterprises
L. Personal Financial Statements
M. Combined Financial Statements

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements
B. Process and Job Order Costing
C. Standard Costing
D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
E. Absorption and Variable Costing
F. Budgeting and Flexible Budgeting
G. Breakeven and Cost-Volume-Profit Analysis
H. Capital Budgeting Techniques
I. Performance Analysis
J. Other

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework
B. Fund Accounting
C. Types of Funds and Account Groups
D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
E. Various Types of Not-for-Profit and Governmental Organizations

Selected Multiple Choice Items — Unofficial Answers
Essays — Selected Questions
Selected Essays — Unofficial Answers
November 1988 Uniform CPA Examination Questions & Unofficial Answers
Suggested References
Index
Content Specification Outlines
MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

B. Conceptual Framework

N86#1. According to the FASB’s conceptual framework, the calculation of comprehensive income includes which of the following?

<table>
<thead>
<tr>
<th>Income from continuing operations</th>
<th>Distributions to owners</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>

N86#2. According to the FASB’s 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>

N87#1. 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>

N87#2. 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>

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. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Accounting Theory

M85#1. Under Statement of Financial Accounting Concepts No. 2, representational faithfulness is an ingredient of

<table>
<thead>
<tr>
<th>Relevance</th>
<th>Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#1. Under Statement of Financial Accounting Concepts No. 2, which of the following relates to both relevance and reliability?

a. Timeliness.
b. Materiality.
c. Verifiability.
d. Neutrality.

M84#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.

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

\[
\begin{array}{c|c|c}
\text{Investments by} & \text{Distributions to} \\
\text{owners} & \text{owners} \\
\hline
\text{a.} & \text{No} & \text{No} \\
\text{b.} & \text{No} & \text{Yes} \\
\text{c.} & \text{Yes} & \text{No} \\
\text{d.} & \text{Yes} & \text{Yes} \\
\end{array}
\]

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.

M84#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.

M84#4. Recognizing depletion expense is an example of the accounting process of

\[
\begin{array}{c|c}
\text{Allocation} & \text{Amortization} \\
\hline
\text{a.} & \text{No} & \text{No} \\
\text{b.} & \text{No} & \text{Yes} \\
\text{c.} & \text{Yes} & \text{Yes} \\
\text{d.} & \text{Yes} & \text{No} \\
\end{array}
\]

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.

E. Consolidated Financial Statements

M88#3. A subsidiary was acquired for cash in a business combination on January 1, 1987. The purchase price exceeded the fair value of identifiable net assets. The acquired company owned equipment with a market value in excess of the carrying amount as of the date of combination. A consolidated balance sheet prepared on December 31, 1987, would

a. Report the unamortized portion of the excess of the market value over the carrying amount of the equipment as part of goodwill.
b. Report the unamortized portion of the excess of the market value over the carrying amount of the equipment as part of plant and equipment.
c. Report the excess of the market value over the carrying amount of the equipment as part of plant and equipment.
d. Not report the excess of the market value over the carrying amount of the equipment because it would be expensed as incurred.

N86#3. 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.
Selected Questions

M84#5. A subsidiary, acquired for cash in a business combination, owned equipment with a market value in excess of book value as of the date of combination. A consolidated balance sheet prepared immediately after the acquisition would treat this excess as
a. Goodwill.
b. Plant and equipment.
c. Retained earnings.
d. Deferred credits.

F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

M88#4. During a period of inflation in which a liability account balance remains constant, which of the following occurs?

a. A purchasing power loss if the item is a nonmonetary liability.
b. A purchasing power gain if the item is a nonmonetary liability.
c. A purchasing power loss if the item is a monetary liability.
d. A purchasing power gain if the item is a monetary liability.

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>

M86#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>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</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

<table>
<thead>
<tr>
<th>End of year</th>
<th>Date of sale</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#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.
A. Cash, Marketable Securities, and Investments

**M88#5.** The amount by which the aggregate market value of a marketable equity securities portfolio exceeds its cost should be accounted for as a valuation allowance when the portfolio is classified as

<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>

**M88#6.** An issuer of bonds is required by its bond indenture agreement to use a sinking fund for the retirement of the bonds. Cash was transferred to the sinking fund. The sinking fund cash was then used to purchase investments. The sinking fund

a. Increases when the investments are purchased.
b. Decreases when the investments are purchased.
c. Increases by revenue earned on the investments.
d. Is not affected by revenue earned on the investments.

**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>

**N86#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.

**N86#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.

**N86#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.
Selected Questions

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.

M84#6. An investor purchased a bond classified as a long-term investment between interest dates at a premium. At the purchase date, the carrying value of the bond is more than the

<table>
<thead>
<tr>
<th>Cash paid to seller</th>
<th>Face value of bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

B. Receivables and Accruals

M88#7. A note receivable bearing a reasonable interest rate is sold to a bank with recourse. The notes receivable discounted account was appropriately credited. The notes receivable discounted account should be reported as a
   a. Contra-asset account for the proceeds from the discounting transaction.
   b. Contra-asset account for the face amount of the note.
   c. Liability account for the proceeds from the discounting transaction.
   d. Liability account for the face amount of the note.

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.

N85#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.

T-5
N84#8. On October 1, 1983, a company received a one-year note receivable bearing interest at the market rate. The face amount of the note receivable and the entire amount of the interest are due on September 30, 1984. The interest receivable account at December 31, 1983 would consist of an amount representing
a. Three months of accrued interest income.
b. Nine months of accrued interest income.
c. Twelve months of accrued interest income.
d. The excess at October 1, 1983 of the present value of the note receivable over its face value.

N84#9. When the allowance method of recognizing bad debt expense is used, the entries at the time of collection of a small account previously written off would
a. Increase net income.
b. Have no effect on total current assets.
c. Increase working capital.
d. Decrease total current liabilities.

N84#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>

N84#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.

C. Inventories

N87#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>

N87#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.

N87#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.

N87#4. 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.

N86#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. 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#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.

N86#9. 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. 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#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>Denominator</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.

**M84#10.** Theoretically, how should the following affect the costs to be included in a manufacturer's inventory?

<table>
<thead>
<tr>
<th>Insurance on</th>
<th>Cash discounts taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>raw materials</td>
<td>on purchased materials</td>
</tr>
<tr>
<td>while in transit</td>
<td>while in transit</td>
</tr>
<tr>
<td>a. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

**M84#11.** Which of the following inventory cost flow methods involves computations based on broad inventory pools of similar items?
   a. Regular quantity of goods LIFO.
   b. Dollar-value LIFO.
   c. Weighted average.
   d. Moving average.

**D. Property, Plant, and Equipment Owned or Leased**

**M88#8.** An expenditure to install an improved electrical system is a

<table>
<thead>
<tr>
<th>Capital expenditure</th>
<th>Revenue expenditure</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>

**M88#9.** A company using the composite depreciation method for its fleet of trucks, cars, and campers retired one of its trucks and received cash from a salvage company. The net carrying amount of these composite asset accounts would be decreased by the
   a. Cash proceeds received and original cost of the truck.
   b. Cash proceeds received.
   c. Original cost of the truck less the cash proceeds.
   d. Original cost of the truck.

**M87#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.
Accounting Theory

N87#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>

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>

N87#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.

N87#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.

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.

N87#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 \( \times 85\% \times 50\% \).
b. Original cost \( \times 50\% \).
c. Original cost \( \times 85\% \times 50\% \times 50\% \).
d. Original cost \( \times 50\% \times 50\% \).

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>
<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>
<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#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.

M85#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.
b. Original cost multiplied by 10.
c. Original cost multiplied by 10 less total salvage value.
d. (Original cost less salvage value) multiplied by 10.

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></th>
<th>Composite depreciation</th>
<th>Group depreciation</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>No</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</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
Accounting Theory

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 fixed assets and a credit to

a. Retained earnings.
b. Additional paid-in capital.
c. Deferred income.
d. Other income.

M84#10. A machine with a four-year estimated useful life and an estimated fifteen-percent salvage value was acquired on January 1. Would depreciation expense using the sum of the years' digits method of depreciation be higher or lower than depreciation expense using the double-declining-balance method of depreciation in the first and second years?

<table>
<thead>
<tr>
<th>First year</th>
<th>Second year</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Higher</td>
<td>Higher</td>
</tr>
<tr>
<td>b. Higher</td>
<td>Lower</td>
</tr>
<tr>
<td>c. Lower</td>
<td>Higher</td>
</tr>
<tr>
<td>d. Lower</td>
<td>Lower</td>
</tr>
</tbody>
</table>

M84#11. A machine with an original estimated useful life of ten years was moved to another location in the factory after it had been in service for three years. The efficiency of the machine is increased for its remaining useful life. The reinstallation costs should be capitalized if the remaining useful life of the machine is

<table>
<thead>
<tr>
<th>Five years</th>
<th>Ten years</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#12. A lease contains a bargain purchase option. In determining the lessee's capitalizable cost at the beginning of the lease term, the payment called for by the bargain purchase option would

a. Not be capitalized.
b. Be subtracted at its present value.
c. Be added at its exercise price.
d. Be added at its present value.

M84#13. The lessee's net carrying value of an asset arising from the capitalization of a lease would be periodically reduced by the

a. Total minimum lease payment.
b. Portion of minimum lease payment allocable to interest.
c. Portion of minimum lease payment allocable to reduction of principal.
d. Amortization of the asset.

E. Intangibles and Other Assets

M88#10. Which of the following costs of goodwill should be capitalized and amortized over their estimated useful lives?

<table>
<thead>
<tr>
<th>Costs of goodwill from a business combination accounted for as a purchase</th>
<th>Costs of developing goodwill internally</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>

M87#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>

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 journal entry has been recorded on December 31, 1986. The balance in the prepaid asset account on December 31, 1986, should be

a. Zero.
b. The same as would have been if the original payment had been debited initially to an expense account.
c. The same as the original payment.
d. Higher than if the original payment had been debited initially to an expense account.

T-10
**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>

**N86#12.** Legal fees incurred in successfully defending a patent suit should be capitalized when the patent has been

<table>
<thead>
<tr>
<th>Internally developed</th>
<th>Purchased from an inventor</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#7.** Which of the following should be expensed as incurred by the franchisee for a franchise with an estimated useful life of ten years?

a. Amount paid to the franchisor for the franchise.
b. Periodic payments to a company, other than the franchisor, for that company's franchise.
c. Legal fees paid to the franchisee's lawyers to obtain the franchise.
d. Periodic payments to the franchisor based on the franchisee's revenues.

**N85#8.** The premium on a three-year insurance policy expiring on December 31, 1985, was paid in total on January 1, 1983. Assuming that the original payment was initially debited to an expense account, and that appropriate adjusting entries have been recorded on December 31, 1983, and 1984, the balance in the prepaid asset account on December 31, 1984, would be

a. Zero.
b. Lower than the balance on December 31, 1985.
c. The same as the original payment.
d. The same as it would have been if the original payment had been initially debited to a prepaid asset account.

**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.

**N84#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>

**N84#19.** The premium on a four-year insurance policy expiring on December 31, 1985 was paid in total on January 1, 1982. Assuming that the original payment was recorded as a prepaid asset, the balance in the prepaid asset account on December 31, 1983 would be

a. Lower than the balance on December 31, 1982.
b. Lower than the balance on December 31, 1984.
c. The same as the balance on December 31, 1985.
d. The same as the original payment.

**M84#14.** The premium on a three-year insurance policy expiring on December 31, 1984 was paid in total on January 1, 1982. Assuming that the original payment was recorded as a prepaid asset, how would total assets and stockholders' equity be affected during 1983?

a. Total assets would decrease and stockholders' equity would increase.
b. Both total assets and stockholders' equity would decrease.
c. Both total assets and stockholders' equity would increase.
d. Neither total assets nor stockholders' equity would change.
### III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

#### A. Payables and Accruals

**M88#11.** On September 1, 1986, a company borrowed cash and signed a two-year interest-bearing note on which both the principal and interest are payable on September 1, 1988. How many months of accrued interest would be included in the liability for accrued interest at December 31, 1986, and December 31, 1987?

<table>
<thead>
<tr>
<th></th>
<th>At December 31, 1986</th>
<th>At December 31, 1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>4 months</td>
<td>16 months</td>
</tr>
<tr>
<td>b.</td>
<td>4 months</td>
<td>4 months</td>
</tr>
<tr>
<td>c.</td>
<td>12 months</td>
<td>24 months</td>
</tr>
<tr>
<td>d.</td>
<td>20 months</td>
<td>8 months</td>
</tr>
</tbody>
</table>

**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

a. Equal to the stated discount rate of 10%.
b. More than the stated discount rate of 10%.
c. Less than the stated discount rate of 10%.
d. Independent of the stated discount rate of 10%.

**M87#11.** Which of the following is classified as an accrued liability?

<table>
<thead>
<tr>
<th>Liability for federal unemployment taxes</th>
<th>Liability for employer’s share of FICA 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>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</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>A customer</th>
<th>An employee</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#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.

**N84#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.

M88#12. A retail store received cash and issued a gift certificate that is redeemable in merchandise. When the gift certificate was issued, a
a. Deferred revenue account should be decreased.
b. Deferred revenue account should be increased.
c. Revenue account should be decreased.
d. Revenue account should be increased.

M87#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 a(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>

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#99. 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

In November 1987, the FASB issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes," superseding APB Opinion No. 11, "Accounting for Income Taxes." Accordingly, all previous examination items covered by APB Opinion No. 11 have been deleted.

D. Capitalized Lease Liability

M87#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.

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, 1984, specified equal minimum annual lease payments due on December 31 of each year. The 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>

**E. Bonds Payable**

**M88#14.** A five-year term bond was issued by a company on January 1, 1986, at a discount. The carrying amount of the bond at December 31, 1987, would be

a. Higher than the carrying amount at December 31, 1986.

b. Lower than the carrying amount at December 31, 1986.

c. The same as the carrying amount at January 1, 1986.


**M88#15.** At the time of conversion of bonds into common stock, the market value of the stock exceeds the net carrying amount of the bonds. A loss on conversion would be recognized when using the

<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>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**M88#16.** When bonds are issued with stock purchase warrants, a portion of the proceeds should be allocated to paid-in capital for bonds issued with

<table>
<thead>
<tr>
<th>Detachable stock purchase warrants</th>
<th>Nondetachable stock purchase warrants</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#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.

Selected Questions

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#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.

N84#23. The market price of a bond is the

a. Present value of its maturity amount plus the present value of all future interest payments.

b. Maturity amount plus the present value of all future interest payments.

c. Maturity amount plus all future interest payments.

d. Present value of its maturity amount only.

N84#24. Theoretically, which of the following could be accounted for as a deferred charge, a reduction of the related debt liability, or an expense of the period of borrowing?

a. Discount on bonds payable.

b. Premium on bonds payable.

c. Bond issue costs.

d. Loss on extinguishment of debt.

N84#25. How would the amortization of discount on bonds payable affect each of the following?

<table>
<thead>
<tr>
<th>Carrying value</th>
<th>Net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>of bond</td>
<td></td>
</tr>
<tr>
<td>a. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

F. Contingent Liabilities and Commitments

M86#17. A lawsuit in connection with a safety hazard exists for a manufactured product. Occurrence of a loss is probable and the amount can be reasonably estimated. This loss contingency should be

<table>
<thead>
<tr>
<th>Accrued</th>
<th>Disclosed in footnotes</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>
Accounting Theory

M87#19. 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. Decreases</td>
<td>No</td>
</tr>
</tbody>
</table>

M85#19. Which of the following contingencies should generally be accrued on the balance sheet when the occurrence of the contingent event is reasonably possible and its amount can be reasonably estimated?

<table>
<thead>
<tr>
<th>Gain contingency</th>
<th>Loss contingency</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</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>

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

A. Preferred and Common Stock

M86#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

M88#18. When collectibility is reasonably assured, the excess of the subscription price over the stated value of the no par common stock subscribed should be recorded as

a. Additional paid-in capital when the common stock is issued.
b. Additional paid-in capital when the subscription is collected.

c. Additional paid-in capital when the subscription is recorded.
d. No par common stock.

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>

C. Retained Earnings and Dividends

M88#19. A property dividend should be recorded in retained earnings at the property's

a. Book value at date of declaration.
b. Book value at date of issuance (payment).
c. Market value at date of declaration.
d. Market value at date of issuance (payment).
N87#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.

N87#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>

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.

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>

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.

M86#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>

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>

M85#17. How would a stock split affect each of the following?

<table>
<thead>
<tr>
<th>Assets</th>
<th>Total stockholders' equity</th>
<th>Additional paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. No effect</td>
<td>No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>c. No effect</td>
<td>No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

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>

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.
D. Treasury Stock and Other Contra Accounts

**M88#20.** Treasury stock was acquired for cash at a price in excess of its original issue price. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect on total stockholders' equity?

<table>
<thead>
<tr>
<th>Acquisition of</th>
<th>Reissuance of</th>
</tr>
</thead>
<tbody>
<tr>
<td>treasury stock</td>
<td>treasury stock</td>
</tr>
<tr>
<td>a.</td>
<td>No effect</td>
</tr>
<tr>
<td>b.</td>
<td>Increase</td>
</tr>
<tr>
<td>c.</td>
<td>Decrease</td>
</tr>
<tr>
<td>d.</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

**N87#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</th>
<th>Reissuance of</th>
</tr>
</thead>
<tbody>
<tr>
<td>treasury stock</td>
<td>treasury stock</td>
</tr>
<tr>
<td>a.</td>
<td>No effect</td>
</tr>
<tr>
<td>b.</td>
<td>No effect</td>
</tr>
<tr>
<td>c.</td>
<td>Increase</td>
</tr>
<tr>
<td>d.</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

**M86#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>

**M85#18.** Ten thousand shares of $20 par value common stock were initially issued at $25 per share. Subsequently, two thousand of these shares were purchased as treasury stock at $30 per share. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect of the purchase of the treasury stock on the amount reported in the balance sheet for each of the following?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>b. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

**N84#29.** The par value method of accounting for treasury stock differs from the cost method in that:

a. Any gain is recognized upon repurchase of stock but a loss is treated as an adjustment to retained earnings.

b. No gains or losses are recognized on the sale of treasury stock using the par-value method.

c. It reverses the original entry to issue the common stock with any difference being shown as an ordinary gain or loss and does not recognize any gain or loss on a subsequent resale of the stock.

d. It reverses the original entry to issue the common stock with any difference between carrying value and purchase price adjusted through paid-in capital and/or retained earnings and treats a subsequent resale like a new issuance of common stock.

**M84#25.** Treasury stock was acquired for cash at more than its par value, and then subsequently sold for cash at more than its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect on additional paid-in capital from treasury stock transactions?

<table>
<thead>
<tr>
<th>Purchase of</th>
<th>Sale of</th>
</tr>
</thead>
<tbody>
<tr>
<td>treasury stock</td>
<td>treasury stock</td>
</tr>
<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>

**M84#25.** Treasury stock was acquired for cash at more than its par value, and then subsequently sold for cash at more than its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect on additional paid-in capital from treasury stock transactions?

<table>
<thead>
<tr>
<th>Purchase of</th>
<th>Sale of</th>
</tr>
</thead>
<tbody>
<tr>
<td>treasury stock</td>
<td>treasury stock</td>
</tr>
<tr>
<td>a. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>b. No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>No effect</td>
</tr>
</tbody>
</table>
E. Stock Options, Warrants, and Rights

M88#21. A company issued rights to its existing shareholders. The rights were issued without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. Additional paid-in capital will be:
   a. Increased when the rights are exercised.
   b. Increased when the rights are issued.
   c. Decreased when the rights are exercised.
   d. Decreased when the rights expire.

N87#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.

M87#34. A company issued rights to its existing shareholders to purchase, for $30 per share, unissued shares 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 par unissued shares of common stock with a par value of $10 per share. When the market value of the common stock was $12 per share, the rights were exercised. Common stock should be credited at $10 per share and
   a. Appropriation for stock retirement credited at $2 per share.

b. No credit made to additional paid-in capital or retained earnings.

c. Additional paid-in capital credited at $2 per share.

d. Retained earnings credited at $2 per share.

M84#24. A company issued rights to its existing shareholders to purchase for $15 per share, 5,000 unissued shares of common stock with a par value of $10 per share. Common stock will be credited at:
   a. $15 per share when the rights are exercised.
   b. $15 per share when the rights are issued.
   c. $10 per share when the rights are exercised.
   d. $10 per share when the rights are issued.

G. Partnerships

M88#22. A partnership is formed by two individuals who were previously sole proprietors. Which of the following parts of the initial investment in the newly created partnership would be recorded at the fair value at the date of the investment?

<table>
<thead>
<tr>
<th>Marketable securities</th>
<th>Inventories</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N87#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.

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.

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

M88#23. A company uses the completed-contract method to account for a long-term construction contract. Revenue is recognized when progress billings are

<table>
<thead>
<tr>
<th>Recorded</th>
<th>Collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M88#24. In a lease that is recorded as a sales-type lease by the lessor, interest revenue
a. Does not arise.
b. Should be recognized over the period of the lease using the interest method.
c. Should be recognized over the period of the lease using the straight-line method.
d. Should be recognized in full as revenue at the lease's inception.

M87#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>

M87#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

<table>
<thead>
<tr>
<th>Wage expense</th>
<th>Sales to customers</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>

N87#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>

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.
Selected Questions

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.

M86#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. 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.

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.

M85#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>

M85#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.

M84#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.

M84#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>
B. Expenses and Losses

M88#25. Depreciation is computed on the original cost less estimated salvage value under which of the following depreciation methods?

<table>
<thead>
<tr>
<th>Double-declining balance</th>
<th>Productive output</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>

M88#26. A sale of goods was denominated in a currency other than the entity’s functional currency. The sale resulted in a receivable that was fixed in terms of the amount of foreign currency that would be received. Exchange rates between the functional currency and the currency in which the transaction was denominated changed so that a loss was incurred. This loss should be included as a

a. Translation loss reported as a component of income from continuing operations.
b. Translation loss reported as a separate component of stockholders’ equity.
c. Transaction loss reported as a component of income from continuing operations.
d. Transaction loss reported as a separate component of stockholders’ equity.

M87#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.

M87#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.

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>
Selected Questions

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></th>
<th>1983</th>
<th>1984</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

M84#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.

C. Provision for Income Tax

In November 1987, the FASB issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes," superseding APB Opinion No. 11, "Accounting for Income Taxes." Accordingly, all previous examination items covered by APB Opinion No. 11 have been deleted.

D. Recurring Versus Nonrecurring Transactions and Events

M88#28. A gain or loss from a transaction that is unusual in nature and infrequent in occurrence should be reported separately as a component of income
   b. After cumulative effect of accounting changes and after discontinued operations of a segment of a business.
   c. Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.
   d. After cumulative effect of accounting changes and before discontinued operations of a segment of a business.

N87#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.
Accounting Theory

**N85#21.** 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.

**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.

**E. Accounting Changes**

**N87#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.

**F. Earnings Per Share**

**M88#29.** Earnings per share data should be reported on the face of the income statement for

<table>
<thead>
<tr>
<th>Income before extraordinary items</th>
<th>Cumulative effect of a change in accounting principle</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>

**N87#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).

**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>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</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>No</td>
</tr>
</tbody>
</table>

**N86#32.** In determining earnings per share in a complex capital structure, which of the following is a common stock equivalent?

<table>
<thead>
<tr>
<th>Nonconvertible preferred stock</th>
<th>Stock option</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#16.** When computing fully diluted earnings per share, convertible securities that are not common stock equivalents are
   a. Recognized only if they are dilutive.
   b. Recognized only if they are anti-dilutive.
   c. Recognized whether they are dilutive or anti-dilutive.
   d. Ignored.
Selected Questions

M85#25. In computing earnings per share, a method of recognizing the use of proceeds that would be obtained upon exercise of options and warrants is the
a. Antidilution method.
b. Common stock equivalents method.
c. Treasury stock method.
d. If-converted method.

M85#25. Antidilutive common stock equivalents would generally be used in the calculation of

<table>
<thead>
<tr>
<th>Primary earnings per share</th>
<th>Fully diluted earnings per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

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.

M84#29. In determining primary earnings per share, dividends on nonconvertible cumulative preferred stock should be

VI. Other Financial Topics

A. Statement of Cash Flows

In November 1987, the FASB issued Statement of Financial Accounting Standards No. 95, “Statement of Cash Flows.” Accordingly, all previous examination questions and unofficial answers pertaining to “Statement of Changes in Financial Position,” covered by APB Opinion No. 19, Reporting Changes in Financial Position, have been deleted.

B. Accounting Policies

M88#32. Which of the following should be disclosed in the summary of significant accounting policies?

<table>
<thead>
<tr>
<th>Composition of plant assets</th>
<th>Inventory pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</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>No</td>
</tr>
</tbody>
</table>

M85#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#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.
Accounting Theory

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 principle</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 benefited 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.

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>

D. Nonmonetary Transactions

M88#33. Company S and Company T exchanged nonmonetary assets. The exchange did not culminate an earning process for either Company S or Company T. Company S paid cash to Company T in connection with the exchange. Realized gain on the exchange, to the extent that the amount of cash exceeds a proportionate share of the carrying amount of the asset surrendered, should be recognized by

<table>
<thead>
<tr>
<th>Company S</th>
<th>Company T</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>

N87#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>

M87#38. 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.
Selected Questions

M86#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

M88#34. A business combination is accounted for appropriately as a pooling of interests. Costs of furnishing information to stockholders related to effecting the business combination should be

a. Capitalized and subsequently amortized over a period not exceeding forty years.

b. Capitalized but not amortized.

c. Deducted directly from retained earnings of the combined corporation.

d. Deducted in determining net income of the combined corporation for the period in which the costs were incurred.

M88#35. Company L acquired all of the outstanding common stock of Company M in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company L determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company M?

a. Fair value

b. Fair value

c. M's carrying amount

d. M's carrying amount

Plant and equipment Long-term debt

a. Fair value M's carrying amount

b. Fair value Fair value

c. M's carrying amount Fair value

d. M's carrying amount M's carrying amount

M87#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?

Fees of finders and consultants Registration fees

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</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>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M87#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

Pooling of interests Purchase

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></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>

M86#34. In a business combination, costs of registering equity securities are a reduction of the otherwise determinable fair value of the securities for a

Pooling of interests Purchase

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></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>

M85#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

Pooling of interests Purchase

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</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>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M85#29. In a business combination accounted for as a purchase, costs of registering equity securities to be issued by the acquiring company are a (an)

a. Expense of the combined company for the period in which the costs were incurred.

b. Direct addition to stockholders' equity of the combined company.

c. Reduction of the otherwise determinable fair value of the securities.

d. Addition to goodwill.
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.

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>

The accrual or deferral of interest costs to allocate cost to each period is appropriate for

For interim financial reporting, a company's income tax provision for the second quarter of 1988 should be determined using the
b. Effective tax rate expected to be applicable for the full year of 1988 as estimated at the end of the first quarter of 1988.
c. Effective tax rate expected to be applicable for the full year of 1988 as estimated at the end of the second quarter of 1988.
d. Effective tax rate expected to be applicable for the second quarter of 1988.

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>

An inventory loss from a market price decline occurred in the first quarter. The loss was not expected to be restored in the fiscal year. However, in the third quarter the inventory had a market price recovery that exceeded the market decline that occurred in the first quarter. For interim financial reporting, the dollar amount of net inventory should
a. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of the market price recovery.
b. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of decrease in the first quarter.
c. Not be affected in the first quarter and increase in the third quarter by the amount of the market price recovery that exceeded the amount of the market price decline.
d. Not be affected in either the first quarter or the third quarter.

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

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.
Selected Questions

H. Segments and Lines of Business

M88#37. In financial reporting for segments of a business enterprise, the revenue of a segment should include

a. Intersegment billings for the cost of shared facilities.
   b. Intersegment sales of services similar to those sold to unaffiliated customers.
   c. Equity in income from unconsolidated subsidiaries.
   d. Extraordinary items.

N87#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>

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>

N85#33. In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include

<table>
<thead>
<tr>
<th>Expenses related to revenue from intersegment sales</th>
<th>Portion of general corporate expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</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#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.

I. Employee Benefits

N87#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.

N87#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.

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>

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

**M88#38.** Which of the following ratios are useful for evaluating the effectiveness with which the company uses its assets?

<table>
<thead>
<tr>
<th>Acid test (quick) ratio</th>
<th>Price earnings 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>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**N87#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>

**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>

### K. Development Stage Enterprises

**M88#39.** A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for

<table>
<thead>
<tr>
<th>Capitalization of costs</th>
<th>Recognition of revenue</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>

**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 in financial position</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>

### L. Personal Financial Statements

**M88#40.** Personal financial statements should report an investment in life insurance in the statement of financial condition as an

a. Asset for the cash value of the policy less the amount of any loans against it.

b. Asset for the cash value of the policy and a liability for the amount of any loans against it.

c. Asset for the face amount of the policy less the amount of any loans against it.

d. Asset for the face amount of the policy less the amount of premiums paid.
Selected Questions

N87#39. Personal financial statements should include

<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>

No.

N87#40. Personal financial statements consist of a statement of financial condition and usually a(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>

Yes.

N85#33. Personal financial statements should present

| a. Assets and liabilities at their historical cost. |

M. Combined Financial Statements

N87#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. 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>

Yes.

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

M86#41. An example of a direct labor cost is wages paid to a

<table>
<thead>
<tr>
<th>Factory machine operator</th>
<th>Supervisor in a factory</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>

No.

M87#45. Direct materials cost is a

<table>
<thead>
<tr>
<th>Period cost</th>
<th>Product cost</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>

No.

N87#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. |

No.

M86#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>

Yes.

N85#36. In developing a factory overhead application rate for use in a process costing system, which of the following could be used in the numerator?

| a. Actual direct labor hours. |
| b. Estimated direct labor hours. |
| c. Actual factory overhead costs. |
| d. Estimated factory overhead costs. |

No.

N85#37. The cost of rent for a manufacturing plant is a

<table>
<thead>
<tr>
<th>Prime cost</th>
<th>Product cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Yes.
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.

M84#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>

B. Process and Job Order Costing

M88#42. In a job order cost system, the use of direct materials previously purchased usually is recorded as an increase in
a. Work in process control.
b. Factory overhead control.
c. Factory overhead applied.
d. Stores control.

M87#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>

M86#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.

M85#38. In a job order cost system, the use of indirect materials would usually be reflected in the general ledger as an increase in
a. Stores control.
b. Work in process control.
c. Factory overhead control.
d. Factory overhead applied.
Selected Questions

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.

M84#49. In a given process costing system, the equivalent units of production are computed using the weighted-average method. With respect to conversion costs, the percentage of completion for the current period only is included in the calculation of the

<table>
<thead>
<tr>
<th>Beginning work in process inventory</th>
<th>Ending work in process inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#36. In a job order cost system, the incidence 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.

C. Standard Costing

M86#43. Under the two-variance method for analyzing factory overhead, the actual factory overhead 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>

M87#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>

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>

M86#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></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. Spending variance.

N85#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.

N85#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>Controlable (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.

N84#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></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>

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

M88#44. In accounting for byproducts, the value of the byproduct may be recognized at the time of

<table>
<thead>
<tr>
<th>Production</th>
<th>Sale</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>

N87#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.

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>
Selected Questions

N86#44. By-products could have which of the following characteristics?

<table>
<thead>
<tr>
<th>Zero costs beyond</th>
<th>Additional costs beyond</th>
</tr>
</thead>
<tbody>
<tr>
<td>split-off</td>
<td>split-off</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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

c. Be used in the computation of operating income but not in the computation of the contribution margin.
d. Be used in the computation of the contribution margin.

N87#46. In an income statement prepared as an internal report using the variable costing method, which of the following terms should appear?

| Gross profit | Operating income |
| (margin) | |
| a. Yes | Yes |
| b. Yes | No |
| c. No | No |
| d. No | Yes |

M87#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. 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.

M85#43. The absorption costing method includes in inventory

<table>
<thead>
<tr>
<th>Fixed factory overhead</th>
<th>Variable factory overhead</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#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.

E. Absorption and Variable Costing

M86#45. In an income statement prepared as an internal report using the variable costing method, variable selling and administrative expenses would

a. Not be used.
b. Be treated the same as fixed selling and administrative expenses.
An allocated portion of fixed factory overhead is included in work in process inventory under

<table>
<thead>
<tr>
<th>Absorption costing</th>
<th>Direct (variable) costing</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

If an income statement is prepared as an internal report, under which of the following methods would the term gross profit most likely appear?

- Both absorption costing and direct (variable) costing.
- Absorption costing but not direct (variable) costing.
- Direct (variable) costing but not absorption costing.
- Neither direct (variable) costing nor absorption costing.

The flexible budget for a company may include

<table>
<thead>
<tr>
<th>Direct material costs</th>
<th>Variable selling costs</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>

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>

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>

When a flexible budget is used, a decrease in production levels within a relevant range would

- Decrease variable cost per unit.
- Decrease total costs.
- Increase total fixed costs.
- Increase variable cost per unit.

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>

A flexible budget is

- Not appropriate when costs and expenses are affected by fluctuations in volume limits.
- Appropriate for any relevant level of activity.
- Appropriate for control of factory overhead but not for control of direct materials and direct labor.
- Appropriate for control of direct materials and direct labor but not for control of factory overhead.

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>

Breakeven analysis assumes that over the relevant range

- Variable costs are nonlinear.
- Fixed costs are nonlinear.
- Selling prices are unchanged.
- Total costs are unchanged.

In using cost-volume-profit analysis to calculate expected unit sales, which of the following should be added to fixed costs in the numerator?

- Predicted operating loss.
- Predicted operating profit.
- Unit contribution margin.
- Variable costs.

Breakeven analysis assumes over the relevant range that

- Total costs are linear.
- Fixed costs are nonlinear.
- Variable costs are nonlinear.
- Selling prices are nonlinear.

The contribution margin ratio always increases when the

- Variable costs as a percentage of net sales increase.
- Variable costs as a percentage of net sales decrease.
- Breakeven point increases.
- Breakeven point decreases.
Selected Questions

**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.

**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>

**M84#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.

**M84#56.** Breakeven analysis assumes linearity over the relevant range with respect to

<table>
<thead>
<tr>
<th>Total costs</th>
<th>Total revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**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.

**H. Capital Budgeting Techniques**

**M88#48.** The capital budgeting technique known as internal rate of return uses

<table>
<thead>
<tr>
<th>Cash flow over entire life of project</th>
<th>Time value of money</th>
<th>Income over entire life of project</th>
<th>Time value of money</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**M87#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>

**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.

**M86#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
M85#45. On May 1, 1985, a company purchased a new machine which it does not have to pay for until May 1, 1987. The total payment on May 1, 1987, will include both principal and interest. Assuming interest at a 10% rate, the cost of the machine would be the total payment multiplied by what time value of money concept?
   a. Future amount of annuity of 1.
   b. Future amount of 1.
   c. Present value of annuity of 1.
   d. Present value of 1.

M85#46. It is assumed that cash flows are reinvested at the rate earned by the investment in which of the following capital budgeting techniques?

<table>
<thead>
<tr>
<th>Internal rate of return</th>
<th>Net present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M84#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.

I. Performance Analysis

M88#49. A company is analyzing the performance of responsibility centers. Controllable costs would be included in the performance reports of which of the following types of responsibility centers?

<table>
<thead>
<tr>
<th>Investment centers</th>
<th>Profit centers</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>

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.

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.

J. Other

M88#50. In statistical analysis, a weighted average using probabilities as weights is the
   a. Standard deviation.
   b. Expected value.
   c. Coefficient of variation.
   d. Objective function.
**Selected Questions**

**N87#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>

**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. 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. One</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

<table>
<thead>
<tr>
<th>Sunk cost</th>
<th>Irrelevant cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**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.

**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)
A. Conceptual Framework

M88#51. Which of the following is an appropriate basis of accounting for a governmental fund of a governmental unit?

<table>
<thead>
<tr>
<th>Accrual basis</th>
<th>Modified accrual basis</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>

N87#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>

M87#51. Under the modified accrual basis of accounting for a governmental unit, revenues should be recognized in the accounting period in which they become available and measurable.

- a. Are earned and become measurable.
- b. Are collected.
- c. Become available and earned.
- d. Become available and measurable.

M86#51. Which of the following is an appropriate basis of accounting for a governmental fund of a governmental unit?

<table>
<thead>
<tr>
<th>Cash 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>

B. Fund Accounting

M88#52. The fund balance reserved for encumbrances account of a governmental unit is decreased when
a. Supplies previously ordered are received.
b. A purchase order is approved.
c. The vouchers are paid.
d. Appropriations are recorded.

M88#53. The revenues control account of a governmental unit is increased when
a. The budget is recorded.
b. Property taxes are recorded.
c. Appropriations are recorded.
d. The budgetary accounts are closed.

N87#52. The estimated revenues control account of a governmental unit is debited when a purchase order is approved?

- a. Appropriations control.
- b. Vouchers payable.
- c. Fund balance reserved for encumbrances.
- d. Encumbrances control.

M87#53. Which of the following accounts of a governmental unit is debited when a purchase order is approved?

- a. Appropriations control.
- b. Vouchers payable.
- c. Fund balance reserved for encumbrances.
- d. Encumbrances control.

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 appropriations, is adopted and recorded in the general ledger at the beginning of the year, the budgetary fund balance account is

- a. Credited at the beginning of the year and no entry made at the end of the year.
- b. Credited at the beginning of the year and debited at the end of the year.
Selected Questions

c. Debited at the beginning of the year and no entry made at the end of the year.
d. Debited at the beginning of the year and credited at the end of the year.

M86#53. Which of the following accounts of a governmental unit is debited when supplies previously ordered are received?
   a. Appropriations control.
   b. Encumbrances control.
   c. Fund balance reserved for encumbrances.
   d. Vouchers payable.

M86#52. Which of the following accounts of a governmental unit is credited when supplies previously ordered are received?
   a. Fund balance reserved for encumbrances.
   b. Encumbrances control.
   c. Expenditures control.
   d. Appropriations control.

M86#53. The revenues control account of a governmental unit is debited when
   a. The budget is recorded at the beginning of the year.
   b. The account is closed out at the end of the year.
   c. Property taxes are recorded.
   d. Property taxes are collected.

M85#53. When a truck is received by a governmental unit, the truck should be recorded in the general fund as a debit to a (an)
   a. Appropriations control.
   b. Encumbrances control.
   c. Fixed asset.
   d. Expenditures control.

M85#52. The appropriations control account of a governmental unit is debited when
   a. The budgetary accounts are closed.
   b. The budget is recorded.
   c. Supplies are purchased.
   d. Expenditures are recorded.

M85#53. Which of the following accounts of a governmental unit is credited when a purchase order is approved?
   a. Encumbrances control.
   b. Fund balance reserved for encumbrances.
   c. Vouchers payable.
   d. Appropriations control.

M84#51. When the budget of a governmental unit is adopted and the estimated revenues exceed the appropriations, the excess is
   a. Credited to fund balance.
   b. Debit to fund balance.
   c. Credited to reserve for encumbrances.
   d. Debit to reserve for encumbrances.

M84#52. The estimated revenues account of a governmental unit is credited when
   a. The budget is closed out at the end of the year.
   b. The budget is recorded.
   c. Property taxes are recorded.
   d. Property taxes are collected.

M84#53. When supplies ordered by a governmental unit are received at an actual price which is less than the estimated price on the purchase order, the encumbrance account is
   a. Credited for the estimated price on the purchase order.
   b. Credited for the actual price for the supplies received.
   c. Debit for the estimated price on the purchase order.
   d. Debit for the actual price for the supplies received.

C. Types of Funds and Account Groups

M88#54. Which of the following funds of a governmental unit uses the modified accrual basis of accounting?
   a. Enterprise funds.
   b. Internal service funds.
   c. Nonexpendable trust funds.
   d. Special revenue funds.

M88#55. Which of the following funds of a governmental unit uses the same basis of accounting as the special revenue fund?
   a. Expendable trust funds.
   b. Nonexpendable trust funds.
   c. Enterprise funds.
   d. Internal service funds.

M88#56. The amount available in debt service funds is an account of a governmental unit that would be included in the
   a. Liability section of the general long-term debt account group.
   b. Liability section of the debt service fund.
   c. Asset section of the general long-term debt account group.
   d. Asset section of the debt service fund.

M88#57. Customers' security deposits that cannot be spent for normal operating purposes were collected by a governmental unit and accounted for in the enterprise fund. A portion of the amount collected was invested in marketable securities. How would the portion in cash and the portion in marketable securities be classified in the balance sheet of the enterprise fund?

| Portion in | Portion in |
| cash       | marketable securities |
| a. Restricted asset | Restricted asset |
| b. Restricted asset | Unrestricted asset |
| c. Unrestricted asset | Unrestricted asset |
| d. Unrestricted asset | Restricted asset |
**Accounting Theory**

**N87#54.** Which of the following funds of a governmental unit recognizes revenues in the accounting period in which they become available and measurable?

- b. General.
- c. Enterprise.
- d. Internal service.

**N87#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>

**N87#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.

**N87#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>

**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>
Selected Questions

**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. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**M85#55.** Which governmental fund would account for fixed assets in a manner similar to a “for-profit” organization?

a. Enterprise.
b. Capital projects.
c. General fixed asset account group.
d. General.

d. General.

**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.

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.

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.

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.

d. Due to special revenue fund.
Accounting Theory

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

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>Account groups</th>
<th>Governmental 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>

N87#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>

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>
</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#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>
</tr>
</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. No</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>

E. Various Types of Not-for-Profit and Governmental Organizations

M88#59. Which of the following funds are usually encountered in a not-for-profit private university?

<table>
<thead>
<tr>
<th>Current funds</th>
<th>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>
Selected Questions

N86#60. Revenue of a hospital from grants specified by the donor for research would normally be included in
   a. Other nonoperating revenue.
   b. Other operating revenue.
   c. Patient service revenue.
   d. Ancillary service revenue.

N87#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>

N87#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. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</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#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.

N86#59. 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>

N87#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>

N87#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.

N86#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>
<th>Tuition waivers</th>
<th>Unrestricted bequests</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

N85#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

N85#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.

N85#59. Which of the following should be included in the current funds revenues of a not-for-profit private university?

T-45
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.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

<table>
<thead>
<tr>
<th>B. Conceptual Framework</th>
<th>M84# 1 b</th>
<th>F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88# 1 b</td>
<td>M84# 2 a</td>
<td>M88# 4 d</td>
</tr>
<tr>
<td>M88# 2 b</td>
<td>C. Basic Concepts and Accounting Principles</td>
<td></td>
</tr>
<tr>
<td>N87# 8 c</td>
<td>M85# 2 a</td>
<td>M87# 2 a</td>
</tr>
<tr>
<td>M87# 1 a</td>
<td>N84# 3 c</td>
<td>N86# 4 a</td>
</tr>
<tr>
<td>N86# 1 b</td>
<td>N84# 4 c</td>
<td>M86# 2 a</td>
</tr>
<tr>
<td>N86# 2 b</td>
<td>M84# 3 c</td>
<td>N85# 4 a</td>
</tr>
<tr>
<td>M86# 1 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N85# 1 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N85# 2 d</td>
<td>E. Consolidated Financial Statements</td>
<td></td>
</tr>
<tr>
<td>M85# 1 d</td>
<td>N84# 6 d</td>
<td></td>
</tr>
<tr>
<td>N84# 1 b</td>
<td>N84# 7 a</td>
<td></td>
</tr>
<tr>
<td>N84# 2 d</td>
<td>M88# 3 a</td>
<td></td>
</tr>
<tr>
<td>N86# 3 c</td>
<td>M84# 4 a</td>
<td></td>
</tr>
<tr>
<td>N84# 5 b</td>
<td>M84# 5 c</td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>A. Cash, Marketable Securities, and Investments</th>
<th>M86# 7 c</th>
<th>D. Property, Plant, and Equipment Owned or Leased</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88# 5 a</td>
<td>M86# 8 d</td>
<td>N84# 14 d</td>
</tr>
<tr>
<td>M88# 6 c</td>
<td>N85# 3 b</td>
<td>N84# 15 d</td>
</tr>
<tr>
<td>N84# 8 a</td>
<td>N84# 9 b</td>
<td>N84# 16 a</td>
</tr>
<tr>
<td>N84# 7 c</td>
<td>M84# 7 b</td>
<td>N84# 17 c</td>
</tr>
<tr>
<td>M84# 8 b</td>
<td>M84# 8 d</td>
<td></td>
</tr>
<tr>
<td>M87# 7 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87# 8 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N86# 14 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N86# 15 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 4 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 5 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 6 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M85# 4 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M85# 6 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M85# 5 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 6 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Receivables and Accruals</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88# 7 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87# 3 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87# 4 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 7 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 9 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N86# 10 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 17 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 18 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 19 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 20 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 21 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N85# 5 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N85# 6 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N85# 7 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Intangibles and Other Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N86# 9 b</td>
<td>M88# 10 d</td>
<td></td>
</tr>
<tr>
<td>M87# 9 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87# 10 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N86# 11 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M86# 12 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 13 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 14 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 15 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 16 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 17 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 18 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 19 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 8 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M85# 10 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 12 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N84# 13 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M84# 14 b</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

#### A. Payables and Accruals

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#11 a</td>
<td>M87#10 b</td>
<td>N87# 12 b</td>
</tr>
<tr>
<td>N86# 16 d</td>
<td>M86#13 b</td>
<td>N85# 9 b</td>
</tr>
<tr>
<td>M85#15 a</td>
<td>N84#21 a</td>
<td>M87#11 c</td>
</tr>
<tr>
<td>M84#16 d</td>
<td>M86#14 b</td>
<td>N86#26 c</td>
</tr>
<tr>
<td>M84#17 d</td>
<td>M86#27 d</td>
<td>N85#11 c</td>
</tr>
</tbody>
</table>

#### B. Deferred Revenues

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#12 b</td>
<td>N87#10 d</td>
<td>M87#12 b</td>
</tr>
<tr>
<td>N85# 9 b</td>
<td>M85#11 a</td>
<td>N86# 16 d</td>
</tr>
<tr>
<td>M86#13 b</td>
<td>M85#14 b</td>
<td>M85#15 a</td>
</tr>
<tr>
<td>N84#21 a</td>
<td>M84#16 d</td>
<td>M84#17 d</td>
</tr>
</tbody>
</table>

#### C. Capitalized Lease Liability

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#15 c</td>
<td>M88#16 c</td>
<td>M87#16 a</td>
</tr>
<tr>
<td>M85#12 a</td>
<td>N85#11 a</td>
<td>M87#17 d</td>
</tr>
<tr>
<td>M84#13 c</td>
<td>M87#11 b</td>
<td>M86#16 a</td>
</tr>
<tr>
<td>N86#18 c</td>
<td>N85#10 d</td>
<td>N85#19 c</td>
</tr>
</tbody>
</table>

#### D. Bonds Payable

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#14 a</td>
<td>N85#24 c</td>
<td>N84#25 a</td>
</tr>
</tbody>
</table>

#### E. Contingent Liabilities and Commitments

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#15 c</td>
<td>M88#16 c</td>
<td>M87#17 d</td>
</tr>
<tr>
<td>M85#12 a</td>
<td>N85#11 a</td>
<td>M87#19 c</td>
</tr>
<tr>
<td>M84#13 c</td>
<td>M87#11 b</td>
<td>M86#28 a</td>
</tr>
<tr>
<td>N86#18 c</td>
<td>N85#10 d</td>
<td>N85#19 d</td>
</tr>
</tbody>
</table>

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

#### A. Preferred and Common Stock

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>N87#15 b</td>
<td>M87#20 c</td>
<td>M87#33 d</td>
</tr>
<tr>
<td>M87#21 a</td>
<td>N86#23 c</td>
<td>M86#31 b</td>
</tr>
<tr>
<td>M85#19 c</td>
<td>M85#18 a</td>
<td>N84#30 b</td>
</tr>
<tr>
<td>N86#22 d</td>
<td>M84#29 d</td>
<td>M84#24 c</td>
</tr>
</tbody>
</table>

#### B. Additional Paid-in Capital

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M86#15 a</td>
<td>M87#17 b</td>
<td>M87#34 b</td>
</tr>
<tr>
<td>M85#12 a</td>
<td>N84#28 d</td>
<td>N86#26 a</td>
</tr>
<tr>
<td>M84#22 a</td>
<td>M85#13 a</td>
<td>M84#30 a</td>
</tr>
</tbody>
</table>

#### C. Retained Earnings and Dividends

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#19 c</td>
<td>M88#20 d</td>
<td>M85#29 c</td>
</tr>
<tr>
<td>N87#14 c</td>
<td>N87#12 b</td>
<td>M87#35 d</td>
</tr>
</tbody>
</table>

#### D. Treasury Stock and Other Contra Accounts

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#21 a</td>
<td>M87#19 a</td>
<td>M84#26 a</td>
</tr>
</tbody>
</table>

### 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

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#23 d</td>
<td>M84#34 c</td>
<td>N85#17 d</td>
</tr>
<tr>
<td>N87#16 d</td>
<td>M87#25 b</td>
<td>M85#23 c</td>
</tr>
<tr>
<td>M87#17 b</td>
<td>M88#26 c</td>
<td>N84#35 d</td>
</tr>
</tbody>
</table>

#### B. Expenses and Losses

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M87#20 a</td>
<td>N87#20 a</td>
<td>M88#27 b</td>
</tr>
<tr>
<td>N86#24 d</td>
<td>M87#22 c</td>
<td>M84#29 a</td>
</tr>
<tr>
<td>M86#33 c</td>
<td>M87#23 d</td>
<td>M87#29 a</td>
</tr>
<tr>
<td>N85#20 b</td>
<td>M87#24 d</td>
<td>M87#33 a</td>
</tr>
<tr>
<td>N85#21 a</td>
<td>M87#25 b</td>
<td>M87#32 b</td>
</tr>
<tr>
<td>M85#21 c</td>
<td>N86#27 a</td>
<td>N86#32 c</td>
</tr>
<tr>
<td>M85#32 c</td>
<td>M86#34 a</td>
<td>M86#16 a</td>
</tr>
<tr>
<td>N84#32 c</td>
<td>N85#16 b</td>
<td>N85#24 a</td>
</tr>
</tbody>
</table>

#### C. Earnings Per Share

<table>
<thead>
<tr>
<th>Item</th>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#29 a</td>
<td>N87#23 a</td>
<td>N85#23 d</td>
</tr>
<tr>
<td>M87#33 a</td>
<td>M87#32 b</td>
<td>N86#32 c</td>
</tr>
<tr>
<td>N85#25 c</td>
<td>N86#31 b</td>
<td>M85#25 d</td>
</tr>
<tr>
<td>N84#37 a</td>
<td>M84#29 d</td>
<td>M86#16 a</td>
</tr>
</tbody>
</table>

T-48
VI. Other Financial Topics

B. Accounting Policies

<table>
<thead>
<tr>
<th>M86#33 c</th>
<th>M86#35 d</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#32 b</td>
<td></td>
</tr>
<tr>
<td>N87#25 a</td>
<td></td>
</tr>
<tr>
<td>M86#36 c</td>
<td>N85#30 c</td>
</tr>
</tbody>
</table>

C. Accounting Changes

<table>
<thead>
<tr>
<th>N87#26 a</th>
<th>M87#30 d</th>
</tr>
</thead>
<tbody>
<tr>
<td>N86#36 c</td>
<td>N85#31 a</td>
</tr>
<tr>
<td>M85#28 c</td>
<td>M84#40 b</td>
</tr>
<tr>
<td>M84#32 b</td>
<td></td>
</tr>
</tbody>
</table>

D. Nonmonetary Transactions

<table>
<thead>
<tr>
<th>M88#33 b</th>
<th>M88#37 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>N87#27 b</td>
<td>N84 #38 d</td>
</tr>
<tr>
<td>M87#38 a</td>
<td>N87#38 d</td>
</tr>
</tbody>
</table>

E. Business Combinations

<table>
<thead>
<tr>
<th>M88#34 d</th>
<th>M88#37 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#35 b</td>
<td>N87#32 c</td>
</tr>
<tr>
<td>N87#28 d</td>
<td>N86#37 d</td>
</tr>
<tr>
<td>N86#34 b</td>
<td>M85#31 d</td>
</tr>
<tr>
<td>N85#32 c</td>
<td>M84#33 b</td>
</tr>
<tr>
<td>M85#29 c</td>
<td></td>
</tr>
<tr>
<td>N84#41 a</td>
<td></td>
</tr>
</tbody>
</table>

F. Interim Financial Statements

<table>
<thead>
<tr>
<th>M88#36 c</th>
<th>N87#30 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>N87#36 b</td>
<td>N86#35 c</td>
</tr>
<tr>
<td>M86#37 c</td>
<td>M85#34 d</td>
</tr>
</tbody>
</table>

G. Gain Contingencies

<table>
<thead>
<tr>
<th>N87#31 c</th>
<th>M87#40 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>N86#39 a</td>
<td>M86#39 a</td>
</tr>
</tbody>
</table>

H. Segments and Lines of Business

<table>
<thead>
<tr>
<th>M88#38 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>N87#38 d</td>
</tr>
</tbody>
</table>

I. Employee Benefits

<table>
<thead>
<tr>
<th>N87#36 a</th>
<th>M88#40 a</th>
</tr>
</thead>
<tbody>
<tr>
<td>N87#37 d</td>
<td>M87#39 c</td>
</tr>
<tr>
<td>M85#34 d</td>
<td>N86#40 b</td>
</tr>
<tr>
<td>M85#33 b</td>
<td></td>
</tr>
</tbody>
</table>

J. Analysis of Financial Statements

<table>
<thead>
<tr>
<th>M88#42 d</th>
</tr>
</thead>
<tbody>
<tr>
<td>N87#38 d</td>
</tr>
</tbody>
</table>

K. Development Stage Enterprises

| M87#40 c |

L. Personal Financial Statements

| N87#40 c |

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

<table>
<thead>
<tr>
<th>M87#43 c</th>
<th>M85#42 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>N86#43 d</td>
<td>N84#53 c</td>
</tr>
<tr>
<td>M86#43 c</td>
<td>M84#46 b</td>
</tr>
<tr>
<td>N85#40 d</td>
<td></td>
</tr>
<tr>
<td>M85#41 b</td>
<td></td>
</tr>
<tr>
<td>N86#41 a</td>
<td></td>
</tr>
<tr>
<td>M85#39 a</td>
<td></td>
</tr>
<tr>
<td>M85#40 a</td>
<td>M88#46 b</td>
</tr>
<tr>
<td>N84#50 b</td>
<td>M87#47 a</td>
</tr>
<tr>
<td>N84#51 b</td>
<td>M87#46 d</td>
</tr>
<tr>
<td>M84#43 b</td>
<td>M86#46 b</td>
</tr>
<tr>
<td>M84#37 a</td>
<td></td>
</tr>
<tr>
<td>M84#44 a</td>
<td></td>
</tr>
<tr>
<td>M84#48 b</td>
<td>M85#43 b</td>
</tr>
<tr>
<td>M84#37 a</td>
<td>M84#40 d</td>
</tr>
<tr>
<td>M84#39 c</td>
<td></td>
</tr>
</tbody>
</table>

B. Process and Job Order Costing

<table>
<thead>
<tr>
<th>M88#44 a</th>
</tr>
</thead>
<tbody>
<tr>
<td>N87#43 d</td>
</tr>
<tr>
<td>M87#44 c</td>
</tr>
<tr>
<td>M86#44 c</td>
</tr>
<tr>
<td>N86#44 d</td>
</tr>
<tr>
<td>N85#50 c</td>
</tr>
<tr>
<td>N85#52 c</td>
</tr>
<tr>
<td>M84#45 a</td>
</tr>
<tr>
<td>M88#45 d</td>
</tr>
<tr>
<td>N87#46 d</td>
</tr>
<tr>
<td>M87#45 a</td>
</tr>
<tr>
<td>N86#45 b</td>
</tr>
<tr>
<td>M85#41 a</td>
</tr>
<tr>
<td>M84#36 a</td>
</tr>
<tr>
<td>M84#42 a</td>
</tr>
</tbody>
</table>

C. Standard Costing

<table>
<thead>
<tr>
<th>M88#43 b</th>
<th>M87#45 a</th>
</tr>
</thead>
<tbody>
<tr>
<td>N86#45 b</td>
<td>M86#48 b</td>
</tr>
<tr>
<td>N85#43 c</td>
<td>M84#49 a</td>
</tr>
</tbody>
</table>

T-49
## Accounting Theory

### VIII. Not-for-Profit and Governmental Accounting

#### A. Conceptual Framework

<table>
<thead>
<tr>
<th>Reference</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>M84#52</td>
<td>52b</td>
</tr>
<tr>
<td>M84#53</td>
<td>56d</td>
</tr>
<tr>
<td>M85#54</td>
<td>58b</td>
</tr>
<tr>
<td>M85#56</td>
<td>58b</td>
</tr>
</tbody>
</table>

#### B. Fund Accounting

<table>
<thead>
<tr>
<th>Reference</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#52</td>
<td>52a</td>
</tr>
<tr>
<td>M88#53</td>
<td>53b</td>
</tr>
<tr>
<td>M87#54</td>
<td>55a</td>
</tr>
<tr>
<td>M87#56</td>
<td>56d</td>
</tr>
</tbody>
</table>

#### C. Types of Funds and Accounts

<table>
<thead>
<tr>
<th>Reference</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#54</td>
<td>54d</td>
</tr>
<tr>
<td>M88#55</td>
<td>55a</td>
</tr>
<tr>
<td>M88#56</td>
<td>56c</td>
</tr>
<tr>
<td>M88#57</td>
<td>57a</td>
</tr>
</tbody>
</table>

#### D. Presentation of Financial Statements

<table>
<thead>
<tr>
<th>Reference</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#58</td>
<td>58a</td>
</tr>
</tbody>
</table>

#### E. Various Types of Not-for-Profit and Governmental Organizations

<table>
<thead>
<tr>
<th>Reference</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#59</td>
<td>59b</td>
</tr>
<tr>
<td>M88#60</td>
<td>60b</td>
</tr>
</tbody>
</table>

---

T-50
ESSAYS — SELECTED QUESTIONS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

M84
Number 4 (Estimated time — — 15 to 25 minutes)

Selected information from the balance sheets of Golden Company and Bridge Company at December 31, 1982, follows:

<table>
<thead>
<tr>
<th></th>
<th>Golden Company</th>
<th>Bridge Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$103,500</td>
<td>$800</td>
</tr>
<tr>
<td>Marketable equity securities, at cost which approximates market</td>
<td>13,000</td>
<td>—</td>
</tr>
<tr>
<td>Accounts receivable, net of allowance for doubtful accounts</td>
<td>55,000</td>
<td>24,700</td>
</tr>
<tr>
<td>Inventories, at lower of cost or market</td>
<td>76,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>2,500</td>
<td>500</td>
</tr>
<tr>
<td>Total current assets</td>
<td>250,000</td>
<td>51,000</td>
</tr>
<tr>
<td>Property, plant, and equipment, net of accumulated depreciation</td>
<td>311,000</td>
<td>62,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>29,000</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>Total assets:</strong></td>
<td>$590,000</td>
<td>$119,000</td>
</tr>
</tbody>
</table>

| **Liabilities:**     |                |                |
| Total liabilities (condensed) | $327,000 | $65,000 |

| **Stockholders' equity:** |                |                |
| Common stock, par value $1.00 per share | 10,000 | 2,000 |
| Additional paid-in capital | 111,000 | 23,000 |
| Retained earnings         | 142,000       | 29,000         |
| **Total stockholders' equity** | 263,000 | 54,000 |
| **Total liabilities and stockholders' equity** | $590,000 | $119,000 |

Additional facts are as follows:

- On January 1, 1983, Golden acquired for cash of $101,000,000 all of the shares of outstanding stock of Bridge. The market (fair) values of Bridge's assets and liabilities on January 1, 1983, were the same as the book values on December 31, 1982, except property, plant and equipment, net of accumulated depreciation, which had a market value of $93,000,000 on January 1, 1983. Golden and Bridge are in similar lines of business.

- Dividends of $400,000 were received during 1983 from the marketable equity securities held by Golden. All of these securities were accounted for by the cost method. Bridge did not pay any dividends to Golden in 1983.
$10,000,000 of the marketable equity securities held by Golden on December 31, 1982 were sold during 1983 for $10,200,000. No marketable equity securities were purchased in 1983. On December 31, 1983, the remaining marketable equity securities portfolio held by Golden had a cost of $3,000,000 and a market value of $2,500,000.

Required:

a. Should consolidated financial statements for Golden and Bridge be presented for 1983? Explain why or why not.

b. If consolidated financial statements were prepared for the year ended December 31, 1983, how should the excess of the cash paid by Golden over the book value of Bridge be accounted for in those consolidated financial statements? Why? Ignore income tax considerations.

c. How should the marketable equity securities transactions and situation described in the additional facts above be accounted for? Why?

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

M88

Number 2 (Estimated time — — 15 to 25 minutes)

Hudson Company, which is both a wholesaler and a retailer, purchases its inventories from various suppliers.

Additional facts for Hudson's wholesale operations are as follows:

- Hudson incurs substantial warehousing costs.
- Hudson uses the lower of cost or market method.
- The replacement cost of the inventories is below the net realizable value and above the net realizable value less the normal profit margin. The original cost of the inventories is above the replacement cost and below the net realizable value.

Additional facts for Hudson's retail operations are as follows:

- Hudson determines the estimated cost of its ending inventories held for sale at retail using the conventional retail inventory method, which approximates lower of average cost or market.
- Hudson incurs substantial freight-in costs.
- Hudson has net markups and net markdowns.

Required:

a. Theoretically, how should Hudson account for the warehousing costs related to its wholesale inventories? Why?

b. 1. In general, why is the lower of cost or market method used to report inventory?
   2. At which amount should Hudson's wholesale inventories be reported on the balance sheet? Explain the application of the lower of cost or market method in this situation.

c. In the calculation of the cost to retail percentage used to determine the estimated cost of its ending retail inventories, how should Hudson treat
   1. Freight-in costs?
   2. Net markups?
   3. Net markdowns?

d. Why does Hudson's retail inventory method approximate lower of average cost or market?

N87

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?
Selected Questions

N87
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. 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?

b. How should Houston report the income statement effects of the securities sold during the year?

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?

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. At which amount should Hanlon's raw materials inventory be reported on the balance sheet? Why?

2. In general, why is the lower of cost or market rule used to report inventory?

c. What would have been the effect on ending inventory and cost of goods sold if Hanlon used the LIFO inventory method instead of the average cost inventory method for the raw materials? Why?

N86
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?

**N85 Number 3 (Estimated time — 15 to 25 minutes)**

Caddell Company, a wholesaler, purchases its inventories from various suppliers FOB destination; it incurs substantial warehousing costs. Caddell uses the dollar value LIFO inventory cost flow method. Caddell also consigns some of its inventories to Reed Company.

Reed also has items for sale that it purchases from other wholesalers. Reed uses the lower of FIFO cost or market inventory method.

**Required:**

a. When should the purchases from various suppliers generally be included in Caddell’s inventory? Why?

b. Theoretically, how should Caddell account for the warehousing costs? Why?

c. 1. What are the advantages of using the dollar value LIFO inventory cost flow method as opposed to the conventional quantity of goods LIFO method?

d. 2. How does the calculation of dollar value LIFO differ from the conventional quantity of goods method?

e. 3. How should Caddell account for the inventories consigned to Reed Company? Why?

**M85 Number 4 (Estimated time — 15 to 25 minutes)**

Walker Company has a noncurrent marketable equity securities portfolio. Walker does not own more than five percent of the outstanding voting stock for any of the securities in the portfolio. At the beginning of the year, the aggregate market value of the portfolio exceeded its cost. Cash dividends on these securities were received during the year. None of the securities in the portfolio were sold during the year. At the end of the year, the aggregate cost of the portfolio exceeded its market value. The decline in the market price of the securities in the portfolio is attributable to general market decline.

During the year, Walker purchased for cash thirty-five percent of the outstanding voting stock of Sipe Company. Cash dividends on this investment were received from Sipe during the year, and the earnings of Sipe after the acquisition date were reported by Sipe to Walker.

**Required:**

a. How should Walker report on its balance sheet and income statement the effects of its investment in the noncurrent marketable equity securities portfolio for the year? Why?

b. How should Walker report on its balance sheet and income statement the effects of its investment in Sipe for the year? Why?

**M85 Number 3 (Estimated time — 15 to 25 minutes)**

On July 1, 1984, Marie Company sold special-order merchandise on credit and received in return an interest-bearing note receivable from the customer. Marie will receive interest at the prevailing rate for a note of this type. Both the principal and interest are due in one lump sum on June 30, 1985.

On September 1, 1984, Marie sold special-order merchandise on credit and received in return a non-interest-bearing note receivable from the customer. The prevailing rate of interest for a note of this type is determinable. The note receivable is due in one lump sum on August 31, 1986.

Marie also has significant amounts of trade accounts receivable as a result of credit sales to its customers. On October 1, 1984, some trade accounts receivable were assigned to Daniel Finance Company on a with recourse, nonnotification basis for an advance of 75% of their amount at an interest charge of 20% on the balance outstanding.
On November 1, 1984, other trade accounts receivable were factored on a without recourse basis. The factor withheld 5% of the trade accounts receivable factored as protection against sales returns and allowances and charged a finance charge of 3%.

**Required:**

a. How should Marie determine the interest income for 1984 on the
   1. interest-bearing note receivable? Why?
   2. noninterest-bearing note receivable? Why?

b. How should Marie report the interest-bearing note receivable and the noninterest-bearing note receivable on its balance sheet at December 31, 1984?

c. How should Marie account for subsequent collections on the trade accounts receivable assigned on October 1, 1984, and the payments to Daniel Finance? Why?

d. How should Marie account for the trade accounts receivable factored on November 1, 1984? Why?

**M84 Number 2 (Estimated time — 15 to 25 minutes)**

Diane Company, a retailer and wholesaler of national brand name household lighting fixtures, purchases its inventories from various suppliers.

**Required:**

a. 1. How should Victoria account for the sale of securities from each portfolio? Why?
   2. How should Victoria account for the marketable equity securities portfolios at year end? Why?

b. 1. How should Victoria account for the disposition prior to their maturity of the long-term bonds called by their issuer? Why?
   2. How should Victoria report the purchase of the additional similar bonds at the date of the acquisition? Why?

**M84 Number 3 (Estimated time — 15 to 25 minutes)**

Victoria Company has both a current and noncurrent marketable equity securities portfolio. At the beginning of the year, the aggregate market value of each portfolio exceeded its cost. During the year, Victoria sold some securities from each portfolio. At the end of the year, the aggregate cost of each portfolio exceeded its market value.

Victoria also has long-term investments in various bonds all of which were purchased for face value. During the year, some of these bonds held by Victoria were called prior to their maturity by the bond issuer. Three months before the end of the year, additional similar bonds were purchased for face value plus two months' accrued interest.

**Required:**

a. 1. What criteria should be used to determine which of Diane's costs are inventoriable?

b. 1. Diane uses the lower of cost or market rule for its wholesale inventories. What are the theoretical arguments for that rule?
   2. The replacement cost of the inventories is below the net realizable value less a normal profit margin, which, in turn, is below the original cost. What amount should be used to value the inventories? Why?

   c. Diane calculates the estimated cost of its ending inventories held for sale at retail using the conventional (lower of average cost or market) retail inventory method. How would Diane treat the beginning inventories, and net markdowns in calculating the cost ratio used to determine its ending inventories? Why?
III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

M88
Number 4 (Estimated time — — 15 to 25 minutes)

On January 1, 1987, Metcalf Company sold equipment for cash and leased it back. As seller-lessee, Metcalf retained the right to substantially all of the remaining use of the equipment.

The term of the lease is eight years. There is a gain on the sale portion of the transaction. The lease portion of the transaction is classified appropriately as a capital lease.

Required:

a. What is the theoretical basis for requiring lessees to capitalize certain long-term leases? Do not discuss the specific criteria for classifying a lease as a capital lease.

b. 1. How should Metcalf account for the sale portion of the sale-leaseback transaction at January 1, 1987?
   2. How should Metcalf account for the leaseback portion of the sale-leaseback transaction at January 1, 1987?
   c. How should Metcalf account for the gain on the sale portion of the sale-leaseback transaction during the first year of the lease? Why?

M87
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?

N86
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:  

- Probable warranty costs on its household appliances are estimated to be 1% of sales.  
- 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?  

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.  

Required:  
   a. What facts above determined that the 11% term bonds were sold at a discount? Why?
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 noninsurable 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?
IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

M85
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?

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M88
Number 3 (Estimated time — 15 to 25 minutes)

There are various types of accounting changes, each of which is required to be reported differently.

Required:

a. What type of accounting change is a change from the sum-of-the-years'-digits method of depreciation to the straight-line method for previously recorded assets? Under what circumstances does this type of accounting change occur?

b. What type of accounting change is a change in the expected service life of an asset arising because of more experience with the asset? Under what circumstances does this type of accounting change occur?

c. With respect to a change in accounting principle:

1. How should a company calculate the effect?

2. How should a company report the effect?

Do not discuss earnings per share requirements.

d. 1. Why are accounting principles, once adopted, normally continued?

2. What is the rationale for disclosure of a change from one accounting principle to another accounting principle?

M87
Number 4 (Estimated time — 15 to 25 minutes)

Carson Company sponsors a single-employer defined benefit pension plan. The plan provides that pension benefits are determined by age, years of service, and compensation. Among the components that should be included in the net pension cost recognized for a period are service cost, interest cost, and actual return on plan assets.

Required:

a. What two accounting problems result from the nature of the defined benefit pension plan? Why do these problems arise?

b. How should Carson determine the service cost component of the net pension cost?

c. How should Carson determine the interest cost component of the net pension cost?

d. How should Carson determine the actual return on plan assets component of the net pension cost?

M88
Number 5 (Estimated time — 15 to 25 minutes)

Carson 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.

N86
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 construction contract using the percentage-of-completion method?

b. How would the income recognized in each year of this long-term construction contract be determined using the cost-to-cost method of determining percentage of completion?

c. What is the effect on income, if any, of the progress billings and the collections on these billings?

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?

M84
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.
Selected Questions

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 purchase, 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?

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?
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.

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

M88
Answer 2 (10 points)

a. Hudson should account for the warehousing costs related to its wholesale inventories as part of inventory. All reasonable and necessary costs of preparing inventory for sale should be recorded as inventory cost. This approach results in proper matching of the warehousing costs with revenue when the wholesale inventories are sold.

b. 1. The lower of cost or market method produces a more realistic estimate of future cash flows to be realized from assets, which is consistent with the principle of conservatism, and recognizes (matches) the anticipated loss in the income statement in the period in which the price decline occurs.

2. Hudson's wholesale inventories should be reported on the balance sheet at replacement cost. According to the lower of cost or market method, replacement cost is defined as market. However, mar-
ket cannot exceed net realizable value and cannot be less than net realizable value less the normal profit margin. In this instance, replacement cost is below original cost, below net realizable value, and above net realizable value less the normal profit margin. Therefore, Hudson's wholesale inventories should be reported at replacement cost.

e. 1. Hudson's freight-in costs should be included only in the cost amounts to determine the cost to retail percentage.
   2. Hudson's net markups should be included only in the retail amounts to determine the cost to retail percentage.
   3. Hudson's net markdowns should not be deducted from the retail amounts to determine the cost to retail percentage.

d. By not deducting net markdowns from the retail amounts to determine the cost to retail percentage, Hudson produces a lower cost to retail percentage than would result if net markdowns were deducted. By applying this lower percentage to ending inventory at retail, the inventory is reported at an amount below cost, which approximates lower of average cost or market.

N87 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.

N87 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.

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 intangible 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.

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.
**Accounting Theory**

**N85**  
**Answer 2** (10 points)

a. The costs that should be capitalized when equipment is purchased for cash should include the gross invoice price of the equipment less discount plus all incidental costs relating to its purchase or preparation for use. Any available discounts whether taken or not should be deducted from the gross invoice price of the equipment.

For equipment purchased under a long-term payment plan, the amount capitalized is the same as for equipment purchased for cash, i.e., the capitalizable cost represents the cash equivalent price. The interest charges should not be capitalized.

b. The physical factors that cause the equipment to depreciate are wear and tear from operation, action of time and other elements, and deterioration and decay. The functional factors that cause the equipment to depreciate are inadequacy, obsolescence, and supersession.

c. The factors that should be considered in computing depreciation expense are the cost of the asset, the estimated residual (salvage) value, and the allocation over the estimated service life of the asset by a systematic and rational allocation procedure.

d. Accelerated depreciation methods are justified based on the following assumptions:

- An asset is more efficient in the earlier years of its estimated useful life. Therefore, larger depreciation charges in the earlier years would be matched against the larger revenues generated in the earlier years.

- Repair expenses on an asset increase in the later years of its estimated useful life. Therefore, smaller depreciation charges in the later years would be combined with the larger repair expenses incurred in the later years resulting in a smooth or level pattern of these expenses.

**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.

M84
Answer 3 (10 points)

a. 1. For both the current and noncurrent marketable equity securities portfolios, the difference between the selling price and the cost is a realized gain or loss that should be included in the net income for the year because a gain or loss should be recognized at the culmination of the earning process, namely, in the year when realization (sale) takes place.

2. Victoria should account for both the current and noncurrent marketable equity securities portfolios at the lower of its aggregate cost or market value, determined at the balance sheet date. Because of the uncertainty of recovery, it is conservative to carry both the current and noncurrent marketable equity securities portfolios at market value when market value is below cost. The amount by which the aggregate cost of the portfolio exceeds the market value should be accounted for as a valuation allowance for both the current and noncurrent marketable equity securities portfolios.

For the current marketable equity securities portfolio, the change in the valuation allowance for the year should be included as a reduction in net income for the year because the portfolio is a current asset and the probability of realization of the loss is sufficiently high to justify inclusion in net income.

For the noncurrent marketable equity securities portfolio, the accumulated change in the valuation allowance should be included in the equity section of the balance sheet and shown separately. In the case of noncurrent marketable equity securities, it is argued that a decline in market value viewed as temporary should not be reflected in net income because the probability of realization is small.

b. Victoria should account for the disposition prior to their maturity of the long-term bonds called by their issuer by recognizing the difference between the call price and the net carrying value of the investment as a gain or loss that should be included in net income for the year because the earning process has been completed and realization has taken place.

c. Victoria should report the purchase price of the additional similar bonds as investment in long-term bonds - a noncurrent asset - and the two months' accrued interest as 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.
Accounting Theory

M84
Answer 2 (10 points)

a. 1. Diane's inventory 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, administrative 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.

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

M88
Answer 4 (10 points)

a. The economic effect of a long-term capital lease on the lessee is similar to that of an installment purchase. Such a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee. Therefore, the lease should be capitalized.

b. 1. Metcalf should account for the sale portion of the sale-leaseback transaction at January 1, 1987, by recording cash for the sale price, decreasing equipment at the undepreciated cost (net carrying amount) of the equipment, and establishing a deferred gain on sale-leaseback for the excess of the sale price of the equipment over its undepreciated cost (net carrying amount).

2. Metcalf should account for the leaseback portion of the sale-leaseback transaction at January 1, 1987, by recording both an asset and a liability at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding any portion of the payments representing executory costs, together with any profit. However, if the present value exceeds the fair value of the leased equipment at January 1, 1987, the amount recorded for the asset and liability should be the equipment's fair value.

c. The deferred gain should be amortized over the lease term or life of asset, whichever is appropriate. During the first year of the lease, the amortization will be an amount proportionate to the amortization of the asset. This deferral and amortization method for a sale-leaseback transaction is required because the lease and the leaseback are two components of a single transaction rather than two independent transactions. Because of this interdependence of the sale and leaseback portions of the transaction, the gain should be deferred and amortized over the lease term.

N87
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.

N87
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.

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 following 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 noncurrent and should be separately identified by Lani in its balance sheet or footnotes thereto. The related obligation recorded under the capital lease should be reported on Lani's December 31, 1984, balance sheet appropriately classified into current and noncurrent categories and should be separately identified by Lani in its balance sheet.

M85
Answer 4 (10 points)

a. The market price of the term bonds would be the sum of the present values of all of the expected net future cash flows discounted at an effective annual interest rate (yield) of 10 percent. The net future cash outflows are the maturity amount (face value) and the series of future semiannual interest payments adjusted for accrued interest received.

The market price of the serial bonds would be determined by computing the market price for each serial separately in the same way that a term bond would be determined and then totaling these prices for the various serials.

b. 1. Immediately after the term bond issue was sold, the current asset—cash—would be increased by the proceeds from the sale of the term bond issue. A noncurrent liability—term bonds payable—would be presented in the balance sheet at the face value of the term bonds, plus the premium. In addition, a current liability—accrued interest payable—would be presented in the balance sheet for accrued interest received (September 1, 1984, to October 1, 1984).

2. Immediately after the serial bond issue was sold, the current asset—cash—would be increased by the proceeds from the sale of the serial bond issue. A noncurrent liability—serial bonds payable—would be presented in the balance sheet at the face value of the serial bonds, less the discount.

c. The bond issue costs incurred in preparing and selling the bond issue could be accounted for as a noncurrent asset—deferred charge. The bond issue cost would then be amortized over the period the bonds will be outstanding, that is, the period from the date of sale (October 1, 1984) to the maturity date (March 1, 1989).

Alternately, under Statements of Financial Accounting Concepts, the bond issue costs incurred in preparing and selling the bond issue could be either accounted for as an expense in 1984, or as a reduction of the noncurrent liability—term bonds payable—and accounted for the same as debt discount.

d. To determine the amount of interest expense for the term bonds for 1984, the net carrying value of the term bonds on October 1, 1984, would be multiplied by the effective interest rate (yield) of 10 percent by one fourth (October 1, 1984, to December 31, 1984).

To determine the amount of interest expense for the serial bonds for 1984, the net carrying value of the serial bonds on November 1, 1984, would be multiplied by the effective interest rate (yield) of 11 percent by one sixth (November 1, 1984, to December 31, 1984).

N84
Answer 2 (10 points)

a. Angela should report the estimated loss from the safety hazard as an expense in the income statement and a liability in the balance sheet because both of the following conditions were met:

- It is considered probable that liabilities have been incurred.
- Based on past experience, a reasonable estimate of the amount of loss can be made.

In addition, Angela should disclose the nature of the safety hazard in the notes to the financial statements.

b. Angela should not report the estimated loss from the noninsurable flood risk as an expense in the income statement or a liability in the balance sheet because no losses have occurred since the warehouse has been uninsured and the asset has not been impaired. Thus, a loss has not been recognized and a liability does not exist. Furthermore, disclosure of the noninsurable risk in the notes to the financial statements is not required because no losses have occurred since the warehouse has been uninsured. Disclosure in the notes to the financial statements is, however, permitted.

c. The purchase of the movie tickets should be accounted for by debiting an asset account—movie tickets inventory—and crediting cash. An accrual for the estimated promotion expense and liability should be accounted for by debiting promotion expense and crediting an accrued liability for those costs associated with 60 percent of the coupons issued. The coupons actually
Accounting Theory

redeemed this year should be accounted for by debiting the accrued liability and crediting the asset account — movie tickets inventory — for 40 percent of the coupons.

M84
Answer 3 (10 points)

a. 1. The selling price of the bond would be the present value of all of the expected net future cash outflows discounted at the effective annual interest rate (yield) of 10 percent. The present value is the sum of the present value of its maturity amount (face value) plus the present value of the series of future semiannual interest payments.

2. Immediately after the bond issue is sold, the current asset, cash, would be increased by the proceeds from the sale of the bond issue. A noncurrent liability, bonds payable, would be presented in the balance sheet at the face value of the bonds less the discount. The bond issue costs incurred in preparing and selling the bond issue would be classified as a noncurrent asset, deferred charge, under generally accepted accounting principles; however, there is theoretical justification for classifying the bond issue costs as either an expense or a reduction of the related debt liability.

b. The following items related to the bond issue would be included in Wesley's 1983 income statement:

- Interest expense would be included for ten months (March 1, 1983, to December 31, 1983) at an effective interest rate (yield) of 10 percent. This is composed of the nominal interest of 8 percent adjusted for the amortization of the related bond discount. Bond discount should be amortized using the interest method over the period the bonds will be outstanding, that is, the period from the date of 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.

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.

IV. 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.
V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M88
Answer 3 (10 points)

a. A change from the sum-of-the-years’-digits method of depreciation to the straight-line method for previously recorded assets is a change in accounting principle. Both the sum-of-the-years’-digits method and the straight-line method are generally accepted. A change in accounting principle results from adoption of a generally accepted accounting principle different from the generally accepted accounting principle used previously for reporting purposes.

b. A change in the expected service life of an asset arising because of more experience with the asset is a change in accounting estimate. A change in accounting estimate occurs because future events and their effects cannot be perceived with certainty. Estimates are an inherent part of the accounting process. Therefore, accounting and reporting for certain financial statement elements requires the exercise of judgment, subject to revision based on experience.

c. 1. The cumulative effect of a change in accounting principle is the difference between (1) the amount of retained earnings at the beginning of the period of change and (2) the amount of retained earnings that would have been reported at that date if the new accounting principle had been used in prior periods.

2. The cumulative effect, net of income taxes, should be shown as a separate item in the income statement for the period of change between the captions “extraordinary items” and “net income”. Pro-forma disclosure of the effects of retroactive restatement should be shown on the face of the income statement.

d. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users of comparative accounting data.

2. If a change in accounting principle occurs, the nature and effect of a change in accounting principle should be disclosed to avoid misleading financial statement users. There is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type.

- Some approach to attributing the cost of pension benefits to individual years of service must be selected.

The two problems arise because a company must recognize pension costs before it pays pension benefits.

b. Carson should determine the service cost component of the net pension cost as the actuarial present value of pension benefits attributable to employee services during a particular period based on the application of the pension benefit formula.

c. Carson should determine the interest cost component of the net pension cost as the increase in the projected benefit obligation due to the passage of time. Measuring the projected benefit obligation requires accrual of an interest cost at an assumed discount rate.

d. Carson should determine the actual return on plan assets component of the net pension cost as the change in the fair value of plan assets during the period, adjusted for (1) contributions and (2) benefit payments.

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.
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.

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 estimate. 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 re-

T-74
Unofficial Answers

reporting entity. This change in reporting entity 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. However, this change in reporting entity should be reported by restating the financial statements of prior periods.

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.

M84
Answer 4 (10 points)

a. Morgan should recognize the change in depreciation method by including the cumulative effect of changing to a new accounting principle in net income of the period of the change.

The amount of cumulative effect is the difference between (1) the amount of retained earnings at the beginning of the period of change and (2) the amount of retained earnings that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods that would have been affected. This difference reflects only the direct effects of the change and the related income tax effect. The amount of the cumulative effect, net of income taxes, should be shown as a separate item in the income statement between the captions “extraordinary items” and “net income.” Pro forma disclosure of the effect of retroactive restatement should be shown on the face of the income statement.

b. The effects of the hailstorm should be reported as an extraordinary item in the income statement because it meets both of the criteria for classification as an extraordinary item. It is unusual in nature and infrequent in occurrence, taking into account the environment in which the entity operates.

c. The classification in the income statement of an extraordinary item differs from that of an operating item in the following ways. First, an extraordinary item should be shown as a separate item in the income statement below the continuing operations section of the income statement. Second, an extraordinary item should be shown net of applicable income taxes. An extraordinary item is unrelated to Morgan’s normal and ongoing operations.

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.
Accounting Theory

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 interest reported would be the same whether the business combination is accounted for as a purchase or a pooling of interests.

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.

VIII. Not-for-Profit and Governmental Accounting

N84
Answer 5 (10 points)

a. In the accrual basis of accounting, revenues should be recognized in the accounting period in which they are earned and become measurable.

In the modified accrual basis of accounting, revenues should be recognized in the accounting period in which they become susceptible to accrual — that is, when they become both measurable and available to finance expenditures of the fiscal period. “Available” means collectible within the current period or soon enough thereafter to be used to pay current period liabilities.

b. For the general fund, the modified accrual basis of accounting should be used because it is a governmental fund, which is, in essence, an accounting segregation of financial resources.

   For the special revenue fund, the modified accrual basis of accounting should be used because it is a governmental fund, which is, in essence, an accounting segregation of financial resources.

   For the enterprise fund, the accrual basis of accounting should be used because it is a proprietary fund, whose ongoing organizations or activities are similar to the organizations or activities found in the private sector; or Kemp’s governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

c. In the general fund, the fixed assets should be accounted for through the general fixed assets account group and the unmatured general long-term liabilities should be accounted for through the general long-term debt account group.

   In the enterprise fund, both the fixed assets and the long-term liabilities should be accounted for in the enterprise fund.

d. When preparing the comprehensive annual financial report (CAFR), the balance sheets of the general fund, the special revenue fund, and the enterprise fund should be combined. The CAFR should contain a combined balance sheet for all fund types and account groups.
Auditing

Selected Questions
And Unofficial Answers
Indexed To
Content Specification
Outline
TABLE OF CONTENTS

Multiple
Choice
Items

Pages

Essays

Selected Questions

I. Professional Responsibilities

A. General Standards and Rules of Conduct A-1
B. Control of the Audit A-5
C. Other Responsibilities A-8

II. Internal Control

A. Definitions and Basic Concepts A-11
B. Study and Evaluation of the System A-13 A-55
C. Cycles A-15 A-59
D. Other Considerations A-19 A-62

III. Evidence and Procedures

A. Audit Evidence A-23 A-62
B. Specific Audit Objectives and Procedures A-30 A-63
C. Other Specific Audit Topics A-32 A-64
D. Review and Compilation Procedures A-37

IV. Reporting

A. Reporting Standards and Types of Reports A-38 A-66
B. Other Reporting Considerations A-48 A-66

Selected Multiple Choice Items — Unofficial Answers A-51

Essays — Selected Questions A-55

Selected Essays — Unofficial Answers A-67

November 1988 Uniform CPA Examination Questions & Unofficial Answers N-1

Suggested References N-76

Index N-81

Content Specification Outlines CSO-1

* No essays were indexed for this group.
† Questions in this area are not classified according to group.
MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Professional Responsibilities

A. General Standards and Rules of Conduct

M88#51. The exercise of due professional care requires that an auditor
a. Use error-free judgment.
b. Study and review internal accounting control, including compliance tests.
c. Critically review the work done at every level of supervision.
d. Examine all corroborating evidence available.

M88#52. Under which of the following circumstances would the independence of a CPA be considered impaired if the CPA, who is also an attorney, serves as auditor and provides legal services to the same client?

a. When the CPA, as legal agent, consummates a business acquisition for the client.
b. When the CPA’s audit fees and legal fees are not billed separately.
c. When the CPA uses legal expertise to research a question of income tax law.
d. When the legal services consist of an analysis of the terms of a lease agreement.

M88#53. A violation of the profession’s ethical standards would most likely have occurred when a CPA
a. Purchased a bookkeeping firm’s practice of monthly write-ups for a percentage of fees received over a three-year period.
b. Made arrangements with a bank to collect notes issued by a client in payment of fees due.
c. Named Smith formed a partnership with two other CPAs and use “Smith & Co.” as the firm name.
d. Issued an unqualified opinion on the 1987 financial statements when fees for the 1986 audit were unpaid.

N87#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.

N87#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.

N87#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.
Auditing

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.

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#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 of Auditing Standards.
d. Statements on Quality Control Standards.

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.
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#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.

N86#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.

M86#6. Which of the following legal situations would be considered to impair the auditor’s independence?
a. An expressed intention by the present management to commence litigation against the auditor alleging deficiencies in audit work for the client, although the auditor considers that there is only a remote possibility that such a claim will be filed.
b. Actual litigation by the auditor against the client for an amount not material to the auditor or to the financial statements of the client arising out of disputes as to billings for management advisory services.
c. Actual litigation by the auditor against the present management alleging management fraud or deceit.
d. Actual litigation by the client against the auditor for an amount not material to the auditor or to the financial statements of the client arising out of disputes as to billings for tax services.

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.
Selected Questions

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#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 accountancy 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.

M85#1. Which of the following best describes what is meant by generally accepted auditing standards?  
   a. Audit objectives generally determined on audit engagements.  
   b. Acts to be performed by the auditor.  
   c. Measures of the quality of the auditor's performance.  
   d. Procedures to be used to gather evidence to support financial statements.

M85#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.

M85#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.

M85#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.

M85#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.
Auditing

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.

b. In conformity with generally accepted accounting principles.

c. With reasonable diligence and without fault or error.

d. To the satisfaction of governmental agencies and investors who rely upon the audit.

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.

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.

N85#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.

N85#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.

N85#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.

N85#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.

Indefinitely.

d. Until the partnership pay-out to the deceased partner's estate is terminated.
Selected Questions

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?

- Reprints of newspaper articles which are laudatory with respect to the firm's expertise.
- Services offered and fees for such services, including hourly rates and fixed fees.
- Educational and professional attainments of partners.
- 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

- An indirect financial interest in the client.
- A direct financial interest in the client.
- No financial interest in the client.
- A partial financial interest in the client.

N84#1. Adequate technical training and proficiency as an auditor encompasses an ability to understand an EDP system sufficiently to identify and evaluate

- The processing and imparting of information.
- Essential accounting control features.
- All accounting control features.
- The degree to which programming conforms with application of generally accepted accounting principles.

N84#51. Which of the following underlies the application of generally accepted auditing standards, particularly the standards of field work and reporting?

- The elements of materiality and relative risk.
- The element of internal control.
- The element of corroborating evidence.
- The element of quality control.

N84#54. Which of the following is responsible for the fairness of the representations made in financial statements?

- Client's management.
- Independent auditor.
- Audit committee.
- AICPA.

B. Control of the Audit

N88#54. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's

- Awareness of the consistency in the application of generally accepted accounting principles between periods.
- Evaluation of all matters of continuing accounting significance.
- Opinion of any subsequent events occurring since the predecessor's audit report was issued.
- Understanding as to the reasons for the change of auditors.

N88#55. When planning an examination, an auditor should

- Consider whether the extent of substantive tests may be reduced based on the results of the internal control questionnaire.
- Make preliminary judgments about materiality levels for audit purposes.
- Conclude whether changes in compliance with prescribed control procedures justifies reliance on them.
- Prepare a preliminary draft of the management representation letter.

N88#56. A difference of opinion regarding the results of a sample can not be resolved between the assistant who performed the auditing procedures and the in-charge auditor. The assistant should

- Refuse to perform any further work on the engagement.
- Accept the judgment of the more experienced in-charge auditor.
- Document the disagreement and ask to be disassociated from the resolution of the matter.
- Notify the client that a serious audit problem exists.

N88#57. A CPA firm studies its personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the firm's adherence to prescribed standards of

- Supervision and review.
- Continuing professional education.
- Professional development.
- Quality control.

N87#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?

- The auditor's estimated occurrence rate of attributes.
- The auditor's preliminary evaluations of risk based on discussions with the client.
- The content of the client's representation letter.
- The type of report to be issued by the auditor.

N87#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

- Audit risk.
- Inherent risk.
- Control risk.
- Detection risk.
Auditing

N87#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.

N87#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.

N87#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.

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 a(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.

M86#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.

M86#20. Before applying principal substantive tests to the details of asset and liability accounts at an interim date, the auditor should
   a. Assess the difficulty in controlling incremental audit risk.
   b. Investigate significant fluctuations that have occurred in the asset and liability accounts since the previous balance-sheet date.
   c. Select only those accounts which can effectively be sampled during year-end audit work.
   d. Consider the compliance tests that must be applied at the balance-sheet date to extend the audit conclusions reached at the interim date.
M85#3. Quality control for a CPA firm, as referred to in Statements on Quality Control Standards, applies to
a. Auditing services only.
  b. Auditing and management advisory services.
  c. Auditing and tax services.
  d. Auditing and accounting and review services.

M85#10. A prospective client’s refusal to grant a CPA permission to communicate with the predecessor auditor will bear directly on the CPA’s ability to
a. Study and evaluate the client’s system of internal control.
  b. Determine the integrity of management.
  c. Determine the beginning balances of the current year’s financial statements.
  d. Establish consistency in application of GAAP between years.

M85#3. Prior to the acceptance of an audit engagement with a client who has terminated the services of the predecessor auditor, the CPA should
a. Contact the predecessor auditor without advising the prospective client and request a complete report of the circumstances 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.

M85#24. The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether
a. There has been a thorough documentation of the internal accounting controls.
  b. The auditor’s system of quality control has been maintained at a high level.
  c. The assistants’ preliminary judgments about materiality differ from the materiality levels of the persons who will rely on the financial statements.
  d. The results are consistent with the conclusions to be presented in the auditor’s report.

M85#26. A part of the auditor’s planning of an audit engagement should be a plan to search for
a. Errors or irregularities that would have a material or immaterial effect on the financial statements.
  b. Errors or irregularities that would have a material effect on the financial statements.
  c. Errors that would have a material effect on the financial statements, but the auditor need not plan to search for irregularities.
  d. Irregularities that would have a material effect on the financial statements, but the auditor need not plan to search for errors.

M85#18. A CPA firm’s personnel partner periodically studies the CPA firm’s personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the CPA firm’s adherence to prescribed standards of
a. Quality control.
  b. Due professional care.
  c. Supervision and review.
  d. Fieldwork.

M85#49. Early appointment of the auditor enables preliminary work to be performed by the auditor which benefits the client in that it permits the examination to be performed in
a. A more efficient manner.
  b. A more thorough manner.
  c. Accordance with quality control standards.
  d. Accordance with generally accepted auditing standards.

N84#21. Which of the following should an auditor obtain from the predecessor auditor prior to accepting an audit engagement?
  a. Analysis of balance sheet accounts.
  b. Analysis of income statement accounts.
  c. All matters of continuing accounting significance.
  d. Facts that might bear on the integrity of management.

N84#55. Anyone inquiring about the professional reputation and standing of a CPA firm may contact the AICPA Division for CPA Firms and expect to receive
  a. Copies of complaints against the CPA firm that are currently being adjudicated by the AICPA Trial Board.
  b. Copies of peer review reports on the CPA firm after the reports have been accepted by the Division.
  c. Information regarding administrative 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.
Auditing

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.

C. Other Responsibilities

M88#58. An entity’s financial statements were misstated over a period of years due to large amounts of revenue being recorded in journal entries that involved debits and credits to an illogical combination of accounts. The auditor could most likely have been alerted to this irregularity by:
   a. Scanning the general journal for unusual entries.
   b. Performing a revenue cut-off test at year-end.
   c. Tracing a sample of journal entries to the general ledger.
   d. Examining documentary evidence of sales returns and allowances recorded after year-end.

M88#59. The refusal of a client’s attorney to provide a representation on the legality of a particular act committed by the client is generally:
   a. Sufficient reason to issue a “subject to” qualified opinion.
   b. Considered to be a scope limitation.
   c. Insufficient reason to modify the auditor’s report due to the attorney’s obligation of confidentiality.
   d. Proper grounds to withdraw from the engagement.

M88#60. If compiled financial statements presented in conformity with the cash receipts and disbursements basis of accounting do not disclose the basis of accounting used, the accountant should:
   a. Disclose the basis in the notes to the financial statements.
   b. Clearly label each page “Unaudited.”
   c. Disclose the basis of accounting in the accountant’s report.
   d. Recompile the financial statements using generally accepted accounting principles.

N87#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.

N87#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.

N87#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.

N87#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.

N87#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.
Selected Questions

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.

N86#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.

N86#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.

N86#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 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#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.

N86#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.

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.

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.

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 BCD Corp. of the illegal contributions, but they refused to take any action because the amounts involved were immaterial to the financial statements.

A-9
M85#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#5. If an auditor detects an illegal act that does not have a material effect on the client's financial statements, the auditor should generally
   a. Require that the circumstances be disclosed in the notes to the financial statements.
   b. Require the illegal act be reported to the proper legal authorities.
   d. Report the circumstances to a high-level officer within the client's firm.

M85#6. A management advisory service engagement, as opposed to a management advisory service consultation, generally involves advice or information given by a CPA that is based upon
   a. An analytical approach and process.
   b. Existing personal knowledge about the client.
   c. An incidental effort devoted to a combination of activities.
   d. The CPA's ability to implement management's recommendations.

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#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.

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.

M84#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.
Selected Questions

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.

N86#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.

N86#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.
   b. The auditor’s detection of illegal acts committed by officials of the auditor’s publicly held client in conjunction with foreign officials should be reported to the Enforcement Division of the Securities and Exchange Commission.

II. Internal Control

A. Definitions and Basic Concepts

M88#2. When considering the objectivity of internal auditors, an independent auditor should
   a. Evaluate the quality control program in effect for the internal auditors.
   b. Examine documentary evidence of the work performed by the internal auditors.
   c. Test a sample of the transactions and balances that the internal auditors examined.
   d. Determine the organizational level to which the internal auditors report.

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.

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.
c. If the auditor of a publicly held company concludes that the effects on the financial statements of a bribe given to a foreign official are not susceptible of reasonable estimation, the auditor’s report should be modified.

d. Every publicly held company must devise, document, and maintain a system of internal accounting controls sufficient to provide reasonable assurances that internal accounting control objectives are met.

**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.

**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.

**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#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#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.
Selected Questions

M84#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.

M84#16. When a data base administrator's position exists within a client organization, the auditor must be aware of the
a. Output effectiveness/efficiency considerations.
b. Need for coded program files.
c. Use of encrypted dialog in a two-way authentication process.
d. Inherent violation of the principle of separation of duties.

M84#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.

B. Study and Evaluation of the System

M88#3. Which of the following statements is not true of the test data approach when testing a computerized accounting system?
a. The test data need consist of only those valid and invalid conditions which interest the auditor.
b. Only one transaction of each type need be tested.
c. The test data must consist of all possible valid and invalid conditions.
d. Test data are processed by the client's computer programs under the auditor's control.

M88#6. An auditor performs a test to determine whether all merchandise for which the client was billed was received. The population for this test consists of all
a. Merchandise received.
b. Vendors' invoices.
c. Canceled checks.
d. Receiving reports.

M88#7. Internal accounting control is ineffective when computer department personnel
a. Participate in computer software acquisition decisions.
b. Design documentation for computerized systems.
c. Originate changes in master files.
d. Provide physical security for program files.

M88#8. An auditor may compensate for a weakness in the internal accounting control system by increasing the
a. Level of detection risk.
b. Extent of compliance testing.
c. Preliminary judgment about audit risk.
d. Extent of analytical review procedures.

N87#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.
**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.

**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.

**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

- b. Echo checks.
- c. A computer log.
- d. Computer generated hash totals.

**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?

- b. Substantive tests.
- c. Preliminary evaluation of the system.
- d. Review of the system design.

**M86#30.** Which of the following statistical sampling methods is most useful to auditors when testing for compliance?

- b. Variable sampling.
- c. Difference estimation.
- d. Discovery sampling.

**M86#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#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

- c. Subsidiary customer accounts ledger.
- d. Sales invoice file.
Selected Questions

M84#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.

C. Cycles

M88#5. The objectives of internal accounting control for a production cycle are to provide assurance that transactions are properly executed and recorded, and that
   a. Custody of work in process and of finished goods is properly maintained.
   b. Production orders are prenumbered and signed by a supervisor.
   c. Raw materials purchases are authorized by the purchasing department.
   d. Independent internal verification of activity reports is established.

M88#9. Internal accounting control is strengthened when the quantity of merchandise ordered is omitted from the copy of the purchase order sent to the
   a. Department that initiated the requisition.
   b. Receiving department.
   c. Purchasing agent.
   d. Accounts payable department.

M88#10. Property acquisitions that are misclassified as maintenance expense would most likely be detected by an internal accounting control system that provides for
   a. Investigation of variances within a formal budgeting system.
   b. Review and approval of the monthly depreciation entry by the plant supervisor.
   c. Segregation of duties of employees in the accounts payable department.
   d. Examination by the internal auditor of vendor invoices and canceled checks for property acquisitions.

M88#11. Sound internal accounting control procedures dictate that defective merchandise returned by customers should be presented to the
   a. Inventory control clerk.
   b. Sales clerk.
   c. Purchasing clerk.
   d. Receiving clerk.

M88#13. An effective system of internal accounting control over the payroll function would include
   a. Verification of agreement of job time tickets with employee clock card hours by a payroll department employee.
   b. Reconciliation of totals on job time tickets with job reports by employees responsible for those specific jobs.
   c. Custody of rate authorization records by the supervisor of the payroll department.
   d. Preparation of payroll transaction journal entries by an employee who reports to the supervisor of the personnel department.

M88#20. Which of the following procedures in the cash disbursements cycle should not be performed by the accounts payable department?
   a. Comparing the vendor’s invoice with the receiving report.
   b. Canceling supporting documentation after payment.
   c. Verifying the mathematical accuracy of the vendor’s invoice.
   d. Signing the voucher for payment by an authorized person.

N87#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.

N87#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.

N87#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.
Auditing

M87#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.

M87#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.

M87#55. Which of the following departments should have the responsibility for authorizing payroll rate changes?
 a. Personnel.
b. Payroll.
c. Treasurer.
d. Timekeeping.

M87#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.

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.

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 controller 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.

N86#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.

N86#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.

N86#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#1. 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#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.

M85#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.

M85#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.

M85#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.

M85#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.

M85#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#9. Which one of the following would the auditor consider to be an incompatible operation if the cashier receives remittances from the mailroom?
   a. The cashier posts the receipts to the accounts receivable subsidiary ledger cards.
   b. The cashier makes the daily deposit at a local bank.
   c. The cashier prepares the daily deposit.
   d. The cashier endorses the checks.

M85#24. Which of the following is an example of a check digit?
   a. An agreement of the total number of employees to the total number of checks printed by the computer.
   b. An algebraically determined number produced by the other digits of the employee number.
   c. A logic test that ensures all employee numbers are nine digits.
   d. A limit check that an employee’s hours do not exceed 50 hours per week.

M85#38. The accounts payable department receives the purchase order form to accomplish all of the following except
   a. Compare invoice price to purchase order price.
   b. Ensure the purchase had been properly authorized.
   c. Ensure the goods had been received by the party requesting the goods.
   d. Compare quantity ordered to quantity purchased.

M85#40. Which of the following internal accounting control procedures could best prevent direct labor from being charged to manufacturing overhead?
   a. Comparison of daily journal entries with factory labor summary.
   b. Examination of routing tickets from finished goods on delivery.
   c. Reconciliation of work in process inventory with cost records.
   d. Recomputation of direct labor based on inspection of time cards.

M85#53. To strengthen internal accounting control over the custody of heavy mobile equipment, the client would most likely institute a policy requiring a periodic
   a. Increase in insurance coverage.
   b. Inspection of equipment and reconciliation with accounting records.
   c. Verification of liens, pledges, and collateralizations.
   d. Accounting for work orders.

A-18
Selected Questions

**M85#60.** For an appropriate segregation of duties, journalizing and posting summary payroll transactions should be assigned to
a. The treasurer's department.
b. General accounting.
c. Payroll accounting.
d. The timekeeping department.

**N84#10.** Carmela Department Stores has a fully integrated EDP accounting system and is planning to issue credit cards to credit worthy customers. To strengthen internal control by making it difficult for one to create a valid customer account number, the company's independent auditor has suggested the inclusion of a check digit which should be placed
a. At the beginning of a valid account number, only.
b. In the middle of a valid account number, only.
c. At the end of a valid account number, only.
d. Consistently in any position.

**N84#36.** To improve accountability for fixed asset retirements, management most likely would implement a system of internal control that includes
a. Continuous analysis of the repairs and maintenance account.
b. Periodic inquiry of plant executives by internal auditors as to whether any plant assets have been retired.
c. Continuous utilization of serially numbered retirement work orders.
d. Periodic inspection of insurance policies by the internal auditors.

**N84#44.** For effective internal control purposes, which of the following individuals should be responsible for mailing signed checks?
 a. Receptionist.
b. Treasurer.
c. Accounts payable clerk.
d. Payroll clerk.

**N84#48.** In updating a computerized accounts receivable file, which one of the following would be used as a batch control to verify the accuracy of posting cash remittances?
 a. The sum of net sales.
b. The sum of cash deposits less discounts taken by customers.
c. The sum of cash deposits plus discounts taken by customers.
d. The sum of net sales plus discounts taken by customers.

**M84#15.** First Federal S & L has an on-line real-time system, with terminals installed in all of its branches. This system will not accept a customer's cash withdrawal instructions in excess of $1,000 without the use of a "terminal audit key." After the transaction is authorized by a supervisor, the bank teller then processes the transaction with the audit key. This control can be strengthened by
a. On-line recording of the transaction on an audit override sheet.
b. Increasing the dollar amount to $1,500.
c. Requiring manual, rather than on-line, recording of all such transactions.
d. Using parallel simulation.

**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.

**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.

**D. Other Considerations**

**M88#15.** A CPA's report expressing an opinion on an entity's internal accounting control system identified several material weaknesses and will be published in the entity's annual report to shareholders. Management
Intends to include a statement asserting that the cost of correcting the weaknesses would exceed the benefits of reducing the risk of errors and irregularities. The CPA should

a. Insist that management's statement not appear in the same document as the CPA's report.
b. Investigate whether the cost of correcting the weaknesses would, in fact, exceed the benefits.
c. Insist that management correct the weaknesses if cost is the only consideration.
d. Not express any opinion as to management's statement.

M88#16. A CPA's study and evaluation of the system of internal accounting control in an audit will generally

a. Be the same as that made in connection with an engagement to express an opinion on the system of internal accounting control.
b. Result in the CPA expressing an opinion on the system of internal accounting control.
c. Be more limited than that made in connection with an engagement to express an opinion on the system of internal accounting control.
d. Be more extensive than that made in connection with an engagement to express an opinion on the system of internal accounting control.

N87#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.

N87#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.

N87#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.

N87#58. The expected population deviation rate of client billing errors is 5%. 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.

N87#59. The risk of incorrect acceptance and the risk of overreliance 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.
Selected Questions

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

24. Symbol A could represent
a. Computation of gross pay.
b. Input of payroll data.
c. Preparation of paychecks.
d. Verification of payrates.

25. Symbol B could represent
a. Computation of net pay.
b. Separation of erroneous time cards.
c. Validation of payroll data.
d. Preparation of the payroll register.

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#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

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.
M86#47. Which of the following flowchart symbols represents online storage?

a. 

b. 

c. 

d. 

N85#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.

N85#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.

N85#60. Which of the following symbolic representations indicates that a sales invoice has been filed?

a. 

M85#23. An underlying feature of random-based selection of items is that each

a. Stratum of the accounting population be given equal representation in the sample.
   b. Item in the accounting population be randomly ordered.
   c. Item in the accounting population should have an opportunity to be selected.
   d. Item must be systematically selected using replacement.

M85#35. In performing compliance testing, the auditor will normally find that

a. The level of risk is directly proportionate to the rate of error.
   b. The rate of deviations in the sample exceeds the rate of error in the accounting records.
   c. The rate of error in the sample exceeds the rate of deviations.
   d. All unexamined items result in errors in the accounting records.

M85#54. During the audit the independent auditor identified the existence of a material weakness in the client's system of internal accounting controls and orally communicated this finding to the client's senior management and audit committee. The auditor should

a. Consider the material weakness a scope limitation and therefore disclaim an opinion.
   b. Document the matter in the working papers and consider the effects of the weakness on the audit.
   c. Suspend all audit activities pending directions from the client's audit committee.
   d. Withdraw from the engagement.

N84#32. In assessing sampling risk, the risk of incorrect rejection and the risk of underreliance on internal accounting control relate to the

a. Efficiency of the audit.
   b. Effectiveness of the audit.
   c. Selection of the sample.
   d. Audit quality controls.
Selected Questions

M84#29. 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.

M84#20. The accountant's report expressing an opinion on an entity's system of internal accounting control should state that the
a. Establishment and maintenance of the system of internal control are the responsibility of management.
b. Objectives of the client's system of internal accounting control are being met.
c. Study and evaluation of the system of internal control was conducted in accordance with generally accepted auditing standards.
d. Inherent limitations of the client's system of internal accounting control were examined.

III. Evidence and Procedures

A. Audit Evidence

M88#21. Which of the following statements is generally correct about the competence of evidential matter?

a. The auditor's direct personal knowledge, obtained through observation and inspection, is more persuasive than information obtained indirectly from independent outside sources.
b. To be competent, evidential matter must be either valid or relevant, but need not be both.
c. Accounting data alone may be considered sufficient competent evidential matter to issue an unqualified opinion on financial statements.
d. Competence of evidential matter refers to the amount of corroborative evidence to be obtained.

M88#22. To establish the existence and ownership of a long-term investment in the common stock of a publicly-traded company, an auditor ordinarily performs a security count or

a. Relies on the client's internal accounting controls if the auditor has reasonable assurance that the control procedures are being applied as prescribed.
b. Confirms the number of shares owned that are held by an independent custodian.
c. Determines the market price per share at the balance sheet date from published quotations.
d. Confirms the number of shares owned with the issuing company.

M88#23. If a client maintains perpetual inventory records in quantities and in dollars, and its internal accounting control over inventory is weak, an auditor would probably

a. Apply gross profit tests to ascertain the reasonableness of the physical counts.
b. Increase the extent of compliance tests of the inventory cycle.
c. Request the client to schedule the physical inventory count at the end of the year.
d. Insist that the client perform physical counts of inventory items several times during the year.

M88#24. An auditor testing long-term investments would ordinarily use analytical review as the primary audit procedure to ascertain the reasonableness of the

a. Valuation of marketable equity securities.
b. Classification of gains and losses on the disposal of securities.
c. Completeness of recorded investment income.
d. Existence and ownership of investments.
**Auditing**

**N87#46.** "Provision has been made for any material loss that might be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices." The foregoing passage is most likely from
   a. A management representation letter.
   b. The explanatory paragraph of an "except for" qualified auditor's report.
   c. A vendor representation letter.
   d. The explanatory paragraph of a "subject to" qualified auditor's report.

**N87#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.

**N87#33.** One reason why an auditor makes an analytical review of the client's operations is to identify
   b. Weaknesses of a material nature in the system of internal accounting control.
   c. Unusual transactions.
   d. Non-compliance with prescribed control procedures.

**N87#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.

**N87#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.

**N87#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 accountant has given substantive attention in the form of legal consultation or representation.

**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.
Selected Questions

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 footing 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.

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.
Auditing

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.

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.

Selected Questions

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. Averting 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.
Auditing

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.

N84#40. The auditor can best verify a client's bond sinking fund transactions and year-end balance by
   a. Confirmation with individual holders of retired bonds.
   b. Confirmation with the bond trustee.
   c. Recomputation of interest expense, interest payable, and amortization of bond discount or premium.
   d. Examination and count of the bonds retired during the year.

N84#56. If a lawyer refuses to furnish corroborating information regarding litigation, claims, and assessments, the auditor should
   a. Honor the confidentiality of the client-lawyer relationship.
   b. Consider the refusal to be tantamount to a scope limitation.
   c. Seek to obtain the corroborating information from management.
   d. Disclose this fact in a footnote to the financial statements.

M84#2. The auditor faces a risk that the examination will not detect material errors in the financial statements. In regard to minimizing this risk, the auditor primarily relies on
   a. Substantive tests.
   b. Compliance tests.
   c. Internal control.
   d. Statistical analysis.

M84#6. In the confirmation of accounts receivable the auditor would most likely
   a. Request confirmation of a sample of the inactive accounts.
   b. Seek to obtain positive confirmations for at least 50% of the total dollar amount of the receivables.
   c. Require confirmation of all receivables from agencies of the federal government.
   d. Require that confirmation requests be sent within one month of the fiscal year-end.
Selected Questions

M84#11. Which of the following expressions is least likely to be included in a client's representation letter?
   a. No events have occurred subsequent to the balance sheet date that require adjustment to, or disclosure in, the financial statements.
   b. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
   c. Management acknowledges responsibility for illegal actions committed by employees.
   d. Management has made available all financial statements and related data.

M84#19. Auditors may use positive and/or negative forms of confirmation requests for accounts receivable. An auditor most likely will use
   a. The positive form to confirm all balances regardless of size.
   b. A combination of the two forms, with the positive form used for large balances and the negative form for the small balances.
   c. A combination of the two forms, with the positive form used for trade receivables and the negative form for other receivables.
   d. The positive form when controls related to receivables are satisfactory, and the negative form when controls related to receivables are unsatisfactory.

M84#22. An auditor should obtain written 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
   a. The auditor and the client's lawyer.
   b. Management and the auditor.
   c. Management, the client's lawyer, and the auditor.
   d. The auditor independently of management.

M84#23. Of the following which is the least persuasive type of audit evidence?
   a. Documents mailed by outsiders to the auditor.
   b. Correspondence between auditor and vendors.
   c. Copies of sales invoices inspected by the auditor.
   d. Computations made by the auditor.

M84#26. As a result of analytical review procedures, the independent auditor determines that the gross profit percentage has declined from 30% in the preceding year to 20% in the current year. The auditor should
   a. Document management's intentions with respect to plans for reversing this trend.
   b. Evaluate management's performance in causing this decline.
   c. Require footnote disclosure.
   d. Consider the possibility of an error in the financial statements.

M84#27. The auditor notices significant fluctuations in key elements of the company's financial statements. If management is unable to provide an acceptable explanation, the auditor should
   a. Consider the matter a scope limitation.
   b. Perform additional audit procedures to investigate the matter further.
   c. Intensify the examination with the expectation of detecting management fraud.
   d. Withdraw from the engagement.

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.

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.
Audit

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.
c. Obtaining corroboration of information furnished by the client.
d. Identifying impaired assets and incurred liabilities.

B. Specific Audit Objectives and Procedures

M88#26. Which of the following cash transfers results in a misstatement of cash at December 31, 1987?

<table>
<thead>
<tr>
<th>Bank Transfer Schedule</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Disbursement</strong></td>
</tr>
<tr>
<td><strong>Recorded in books</strong></td>
</tr>
<tr>
<td><strong>Transfer</strong></td>
</tr>
<tr>
<td>a. 12/31/87</td>
</tr>
<tr>
<td>c. 12/31/87</td>
</tr>
</tbody>
</table>

M88#27. An auditor should trace corporate stock issuances and treasury stock transactions to the
a. Numbered stock certificates.
b. Articles of incorporation.
c. Transfer agent’s records.
d. Minutes of the board of directors.

M88#28. Which of the following procedures would an auditor most likely rely on to verify management’s assertion of completeness?
a. Review standard bank confirmations for indications of kiting.
b. Compare a sample of shipping documents to related sales invoices.
c. Observe the client’s distribution of payroll checks.
d. Confirm a sample of recorded receivables by direct communication with the debtors.

M88#29. Working papers ordinarily would not include
a. Initials of the in-charge auditor indicating review of the staff assistants’ work.
b. Cut-off bank statements received directly from the banks.
c. A memo describing the preliminary review of the internal accounting control system.
d. Copies of client inventory count sheets.

M88#30. The current file of the auditor’s working papers generally should include
a. A flowchart of the internal accounting controls.
b. Organization charts.
c. A copy of the financial statements.
d. Copies of bond and note indentures.

N87#31. An audit working paper that reflects the major components of an amount reported in the financial statements is referred to as a(n)

a. Lead schedule.
b. Supporting schedule.
c. Audit control account.
d. Working trip balance.

N87#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.

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.

N86#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.

N86#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.

N86#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.

N85#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.

N85#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.

N85#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. Noneupitalizable expenditures have been properly expensed.
   d. Expenditures for fixed assets have been capitalized.
**Auditing**

**M84#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.

**M84#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.

**M84#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.

**C. Other Specific Audit Topics**

**M88#17.** Using microcomputers in auditing may affect the methods used to review the work of staff assistants because
a. Supervisory personnel may not have an understanding of the capabilities and limitations of microcomputers.
b. Working paper documentation may not contain readily observable details of calculations.
c. The audit field work standards for supervision may differ.
d. Documenting the supervisory review may require assistance of management services personnel.

**M88#31.** Processing data through the use of simulated files provides an auditor with information about the reliability of controls. One of the techniques involved in this approach makes use of
a. Controlled reprocessing.
b. Integrated test facility.
c. Input validation.
d. Program code checking.

**M88#33.** A number of factors influences the sample size for a substantive test of details of an account balance. All other factors being equal, which of the following would lead to a larger sample size?

a. Greater reliance on internal accounting controls.
b. Greater reliance on analytical review procedures.
c. Smaller expected frequency of errors.
d. Smaller measure of tolerable error.

**M88#34.** Which of the following statements is correct concerning the auditor's use of statistical sampling?

a. An auditor needs to estimate the dollar amount of the standard deviation of the population to use classical variables sampling.
b. An assumption of PPS sampling is that the underlying accounting population is normally distributed.
c. A classical variables sample needs to be designed with special considerations to include negative balances in the sample.
d. The selection of zero balances usually does not require special sample design considerations when using PPS sampling.

**M88#35.** Which of the following statements is correct concerning related party transactions?

a. In the absence of evidence to the contrary, related party transactions should be assumed to be outside the ordinary course of business.
b. An auditor should determine whether a particular transaction would have occurred if the parties had not been related.
c. An auditor should substantiate that related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions.
d. The audit procedures directed toward identifying related party transactions should include considering whether transactions are occurring, but are not being given proper accounting recognition.

**M88#36.** Ajax Company's auditor concludes that the omission of an audit procedure considered necessary at the time of the prior examination impairs the auditor's present ability to support the previously expressed un-
qualifying opinion. If the auditor believes there are stockholders currently relying on the opinion, the auditor should promptly
a. Notify the stockholders currently relying on the previously expressed unqualified opinion that they should not rely on it.
b. Advise management to disclose this development in its next interim report to the stockholders.
c. Advise management to revise the financial statements with full disclosure of the auditor’s inability to support the unqualified opinion.
d. Undertake to apply the omitted procedure or alternate procedures that would provide a satisfactory basis for the opinion.

M88#37. A governmental audit may extend beyond an examination leading to the expression of an opinion on the fairness of financial presentation to include

<table>
<thead>
<tr>
<th>Program results</th>
<th>Compliance</th>
<th>Economy &amp; efficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M88#38. Which of the following procedures would an auditor most likely perform to obtain evidence about an entity’s subsequent events?

a. Reconcile bank activity for the month after the balance sheet date with cash activity reflected in the accounting records.
b. Examine on a test basis the purchase invoices and receiving reports for several days after the inventory date.
c. Review the treasurer’s monthly reports on temporary investments owned, purchased, and sold.

M88#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.

M67#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.

M67#34. Which of the following is not a major reason why an accounting audit trail should be maintained for a computer system?

A-33
**Auditing**

**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.

**M87#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.

**M86#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 EDI files.
c. Identify weaknesses in the client's EDI controls.
d. Test the accuracy of the client's computations.

**M86#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.

**M86#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.

**M86#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.

**M86#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.

**M86#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.

**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.
Selected Questions

M 86#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.

M 86#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.

N 85
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 publically 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.

M 85#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.

M 85#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.

N 85#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.

N 85#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.

N 85#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.
Auditing

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#31. When an auditor tests a computerized accounting system, which of the following is true of the test data approach?
   a. Test data are processed by the client's computer programs under the auditor's control.
   b. Test data must consist of all possible valid and invalid conditions.
   c. Testing a program at year-end provides assurance that the client's processing was accurate for the full year.
   d. Several transactions of each type must be tested.

N84#11. Which of the following methods of testing application controls utilizes a generalized audit software package prepared by the auditors?
   a. Parallel simulation.
   b. Integrated testing facility approach.
   c. Test data approach.
   d. Exception report tests.

N84#13. Which of the following models expresses the general relationship of risks associated with the auditor's evaluation of internal accounting controls (IC), analytical review procedures and other relevant substantive tests (AR), and ultimate audit risk (UR), that would lead the auditor to conclude that additional substantive tests of details of an account balance are not necessary?

<table>
<thead>
<tr>
<th>AR</th>
<th>IC</th>
<th>UR</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>20%</td>
<td>40%</td>
</tr>
<tr>
<td>b.</td>
<td>20%</td>
<td>60%</td>
</tr>
<tr>
<td>c.</td>
<td>10%</td>
<td>70%</td>
</tr>
<tr>
<td>d.</td>
<td>30%</td>
<td>40%</td>
</tr>
</tbody>
</table>

N84#14. Using statistical sampling to assist in verifying the year-end accounts payable balance, an auditor has accumulated the following data:

<table>
<thead>
<tr>
<th>Number of accounts</th>
<th>Book balance</th>
<th>Balance determined by the auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>4,100</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Sample</td>
<td>200</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

Using the ratio estimation technique, the auditor's estimate of year-end accounts payable balance would be
   a. $6,150,000
   b. $6,000,000
   c. $5,125,000
   d. $5,050,000

N84#19. Which of the following is not among the errors that an auditor might include in the test data when auditing a client's EDP system?
   a. Numeric characters in alphanumerical fields.
   b. Authorization code.
   c. Differences in description of units of measure.
   d. Illogical entries in fields whose logic is tested by programmed consistency checks.
Selected Questions

M84#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.

M84#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.

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.

D. Review and Compilation Procedures

M88#30. When providing limited assurance that the financial statements of a nonpublic entity require no material modifications to be in accordance with generally accepted accounting principles, the accountant should
   a. Understand the system of internal accounting control that the entity uses.
   b. Test the accounting records that identify inconsistencies with the prior year’s financial statements.
   c. Understand the accounting principles of the industry in which the entity operates.
   d. Develop audit programs to determine whether the entity’s financial statements are fairly presented.

M88#40. Which of the following procedures is not usually performed by the accountant in a review engagement of a nonpublic entity?
   a. Communicating any material weaknesses discovered during the study and evaluation of internal accounting control.
   b. Reading the financial statements to consider whether they conform with generally accepted accounting principles.
   c. Writing an engagement letter to establish an understanding regarding the services to be performed.
   d. Issuing a report stating that the review was performed in accordance with standards established by the AICPA.
In April 1988, the Auditing Standards Board issued Statement on Auditing Standards No. 58, “Reports on Audited Financial Statements,” superseding SAS No. 2, “Reports on Audited Financial Statements” (1974). Accordingly, all previous examination items covered by SAS No. 2 have been deleted.

A. Reporting Standards and Types of Reports

An auditor reporting on comparative financial statements is not required to include an explanatory paragraph in the auditor’s report if the opinion paragraph is modified because of an:

a. Change in accounting principle.
b. Scope limitation.
c. Disclaimer of opinion.
d. Uncertainty affecting the financial statements.

A-38
Selected Questions

M88#42. Performing inquiry and analytical procedures is the primary basis for an accountant to issue a (an)
   a. Compilation report on financial statements for a nonpublic entity in its first year of operations.
   b. Review report on comparative financial statements for a nonpublic entity in its second year of operations.
   c. Management advisory report prepared at the request of a client's audit committee.
   d. Internal accounting control report for a governmental agency in accordance with GAO standards.

M88#43. Which of the following representations does an auditor make explicitly and which implicitly when issuing an unqualified opinion?

<table>
<thead>
<tr>
<th>Conformity with GAAP</th>
<th>Adequacy of disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Explicitly</td>
<td>Explicitly</td>
</tr>
<tr>
<td>b. Implicitly</td>
<td>Implicitly</td>
</tr>
<tr>
<td>c. Implicitly</td>
<td>Explicitly</td>
</tr>
<tr>
<td>d. Explicitly</td>
<td>Implicitly</td>
</tr>
</tbody>
</table>

M88#44. The fourth standard of reporting requires the auditor's report to contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. The objective of the fourth standard is to prevent
   a. An auditor from expressing different opinions on each of the basic financial statements.
   b. Restrictions on the scope of the examination, whether imposed by the client or by the inability to obtain evidence.
   c. Misinterpretations regarding the degree of responsibility the auditor is assuming.
   d. An auditor from reporting on one basic financial statement and not the others.

M88#45. An auditor's report expresses an unqualified opinion and includes a middle paragraph that emphasizes a matter included in the notes to the financial statements. The auditor's report would be deficient if the middle paragraph states that the entity
   a. Has changed from the completed-contract method to the percentage of completion method of accounting for long-term construction contracts.
   b. Has had a significant subsequent event.
   c. Has accounting reclassifications that enhance the comparability between the current and prior year.
   d. Is a component of a larger business enterprise.

M88#47. For a particular entity's financial statements to be presented fairly in conformity with generally ac-
cepted accounting principles, it is not required that the principles selected
   a. Be appropriate in the circumstances for the particular entity.
   b. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
   c. Present information in the financial statements that is classified and summarized in a reasonable manner.
   d. Be applied on a basis consistent with those followed in the prior year.

M88#48. Which of the following circumstances requires modification of the accountant's report on a review of interim financial information of a publicly held entity?

<table>
<thead>
<tr>
<th>An uncertainty</th>
<th>Inadequate disclosure</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>

M88#49. An auditor's report issued in connection with which of the following is generally not considered to be a special report?
   a. Compliance with aspects of contractual agreements unrelated to audited financial statements.
   b. Specified elements, accounts, or items of a financial statement presented in a document.
   c. Financial statements prepared in accordance with an entity's income tax basis.
   d. Financial information presented in a prescribed schedule that requires a prescribed form of auditor's report.

N87#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.

N87#2. When a question arises about an entity's continued existence, the auditor should consider factors tending to mitigate the significance of contrary infor-
Auditing

mation 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.

N87#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.

N87#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.

N87#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.

N87#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.

N87#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.

N87#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.

N87#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.

N87#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.

N87#40. An accountant has been asked to issue a review report on the balance sheet of a nonpublic com-
pany 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.

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#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 a(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#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 period have been examined by a predecessor auditor whose report is not presented, the successor auditor should indicate in the scope paragraph
a. The reasons why the predecessor auditor’s report is not presented.
b. The identity of the predecessor auditor who examined the financial statements of the prior year.
c. Whether the predecessor auditor’s review of the current year’s financial statements revealed any matters that might have a material effect on the successor auditor’s opinion.
d. The type of opinion expressed by the predecessor auditor.

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. Disclaim an opinion on whether the statements were examined in accordance with generally accepted auditing standards.
c. Not 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#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.
N86#45. 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(n)
   a. Adverse opinion.
   b. Unqualified opinion.
   c. "Except for" qualified opinion.
   d. "Subject to" qualified opinion.

N86#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.

N86#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.

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 in the form of financial statements 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#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.

N86#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.
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.

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.
Selected Questions

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 cannot be applied, although the independent auditor was able to examine satisfactory evidence for all other items in the financial statements. The independent auditor should issue a(an)
   a. Disclaimer of opinion.
   b. Adverse opinion.
   c. "Subject to" qualified opinion.
   d. "Except for" qualified opinion.

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#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.

M85#11. Compiled financial statements should be accompanied by a report stating all of the following except
   a. The accountant does not express an opinion or any other form of assurance on them.
   b. A compilation has been performed.
   c. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
   d. A compilation consists principally of inquiries of company personnel and analytical procedures applied to financial data.

M85#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#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)

<table>
<thead>
<tr>
<th>&quot;Except for&quot; opinion</th>
<th>Disclaimer of an opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>
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.

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.

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.

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.

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.

The fourth reporting standard requires the auditor's report to contain either an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion cannot be expressed. The objective of the fourth standard is to prevent:

a. An auditor from reporting on one basic financial statement and not the others.
b. An auditor from expressing different opinions on each of the basic financial statements.
c. Management from reducing its responsibility for the basic financial statements.
d. Misinterpretations regarding the degree of responsibility the auditor is assuming.

An auditor's opinion reads as follows: "In our opinion, except for the above-mentioned limitation on the scope of our examination . . ." This is an example of a (an):

a. Review opinion.
b. Emphasis of a matter.
c. Qualified opinion.
d. Unacceptable reporting practice.

When a client will not make essential corporate minutes available to the auditor, the audit report will probably contain a (an):

a. Unqualified opinion.
b. Adverse opinion.
c. Qualified opinion.
d. Disclaimer of opinion.

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.

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.
Selected Questions

M84#58. The auditor who wishes to point out that the entity has significant transactions with related parties should disclose this fact in
a. An explanatory paragraph to the auditor's report.
b. An explanatory footnote to the financial statements.
c. The body of the financial statements.
d. The "Summary of significant accounting policies" section of the financial statements.

M84#3. When the audited financial statements of the prior year are presented together with those of the current year, the continuing auditor's report should cover
a. Both years.
b. Only the current year.
c. Only the current year, but the prior year's report should be presented.
d. Only the current year, but the prior year's report should be referred to.

M84#4. An auditor's report on financial statements that are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles should preferably include all of the following, except
a. Disclosure of the fact that the financial statements are not intended to be presented in conformity with generally accepted accounting principles.
b. An opinion as to whether the use of the disclosed method is appropriate.
c. An opinion as to whether the financial statements are presented fairly in conformity with the basis of accounting described.
d. An opinion as to whether the disclosed basis of accounting has been applied in a manner consistent with the preceding period.

M84#9. Each page of the financial statements compiled by an accountant should include a reference such as
a. See accompanying accountant's footnotes.
b. Unaudited, see accountant's disclaimer.
c. See accountant's compilation report.
d. Subject to compilation restrictions.

M84#17. During a review of financial statements of a non-public entity, the CPA would be least likely to
a. Perform analytical procedures designed to identify relationships that appear to be unusual.
b. Obtain written confirmation from management regarding loans to officers.
c. Obtain reports from other accountants who reviewed a portion of the total entity.
d. Read the financial statements and consider conformance with generally accepted accounting principles.

M84#39. The predecessor auditor, who is satisfied after properly communicating with the successor auditor, has reissued a report because the audit client desires comparative financial statements. The predecessor auditor's report should make
a. No reference to the report or the work of the successor auditor.
b. Reference to the work of the 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.

M84#43. When, in the auditor's judgment, the financial statements are not presented fairly in conformity with generally accepted accounting principles, the auditor will issue a(an)
 a. Qualified opinion.
b. Special report.
c. Disclaimer of opinion.
d. Adverse opinion.

M84#45. An auditor's examination reveals a misstatement in segment information that is material in relation to the financial statements taken as a whole. If the client refuses to make modifications to the presentation of segment information the auditor should issue a(an)
 a. "Except for" opinion.
b. "Subject to" opinion.
c. Unqualified opinion.
d. Disclaimer of opinion.

M84#52. If an accounting change has no material effect on the financial statements in the current year, but the change is reasonably certain to have a material effect in later years, the change should be
a. Treated as a consistency modification in the auditor's report for the current year.
b. Disclosed in the notes to the financial statements of the current year.
c. Disclosed in the notes to the financial statements and referred to in the auditor's report for the current year.
d. Treated as a subsequent event.

M84#53. An auditor's report included an additional paragraph disclosing that there is a difference of opinion between the auditor and the client for which the auditor believed an adjustment to the financial statements should be made. The opinion paragraph of the auditor's report most likely expressed a(an)
 a. Unqualified opinion.
b. "Except for" opinion.
c. "Subject to" opinion.
d. Disclaimer of opinion.
Auditing

M84#57. When comparative financial statements are presented, the fourth standard of reporting, which refers to financial statements "taken as a whole," should be considered to apply to the financial statement of the
a. Periods presented plus one preceding period.
b. Current period only.
c. Current period and those of the other periods presented.
d. Current and immediately preceding period only.

B. Other Reporting Considerations

M88#50. Information accompanying the basic financial statements in an auditor-submitted document should not include
a. An analysis of inventory by location.
b. A statement that the allowance for doubtful accounts is adequate.
c. A statement that the depreciable life of a new asset is 20 years.
d. An analysis of revenue by product line.

N87#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.

N87#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. Report under federal security statutes.
b. Comfort letter.
c. Review of interim financial information.
d. Compilation report for underwriters.

N87#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.

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#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#58. 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.
**Selected Questions**

**N86#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.

**N86#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.

**N86#60.** Comfort letters are ordinarily signed by the

a. Client.
b. Client’s lawyer.
c. Independent auditor.
d. Internal auditor.

**M86#8.** 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#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.

**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#4.** Which of the following best describes the auditor’s responsibility for “other information” included in the annual report to stockholders which contains financial statements and the auditor’s report?

a. The auditor has **no** obligation to read the “other information.”
b. The auditor has **no** obligation to corroborate the “other information,” but should read the “other information” to determine whether it is materially inconsistent with the financial statements.
c. The auditor should extend the examination to the extent necessary to verify the “other information.”
d. The auditor must modify the auditor’s report to state that the “other information is unaudited” or “**not** covered by the auditor’s report.”
Auditing

N84#6. The auditor's report should be dated as of the date on which the
   a. Report is delivered to the client.
   b. Field work is completed.
   c. Fiscal period under audit ends.
   d. Review of the working papers is completed.

N84#7. If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may express an opinion which states that the accompanying information is fairly stated in
   a. Conformity with generally accepted accounting principles.
   b. Terms of negative assurance.
   c. All material respects in relation to the basic financial statements taken as a whole.
   d. Conformity with principles for presenting accompanying information.

N84#12. In which of the following circumstances may the auditor issue the standard audit report?
   a. The principal auditor assumes responsibility for the work of another auditor.
   b. The financial statements are affected by a departure from a generally accepted accounting principle.
   c. The auditor's report covers the company's first year of operations.
   d. The auditor wishes to emphasize a matter regarding the financial statements.

N84#30. The auditor's inquiries of management regarding supplementary information on the effects of price level changes should be directed to the judgments made concerning
   a. Relevance and validity.

b. Measurement and presentation.
   c. Accuracy and objectivity.
   d. Rights and obligations.

M84#42. Jones, CPA, examined the 1983 financial statements of Ray Corp. and issued an unqualified opinion on March 10, 1984. On April 2, 1984, Jones became aware of a 1983 transaction that may materially affect the 1983 financial statements. This transaction would have been investigated had it come to Jones' attention during the course of the examination. Jones should
   a. Take no action because an auditor is not responsible for events subsequent to the issuance of the auditor's report.
   b. Contact Ray's management and request their cooperation in investigating the matter.
   c. Request that Ray's management disclose the possible effects of the newly discovered transaction by adding an unaudited footnote to the 1983 financial statements.
   d. Contact all parties who might rely upon the financial statements and advise them that the financial statements are misleading.

M84#58. When an auditor submits a document containing audited financial statements to a client, the auditor has a responsibility to report on
   a. Only the basic financial statements included in the document.
   b. The basic financial statements and only that additional information required to be presented in accordance with provisions of the Financial Accounting Standards Board.
   c. All of the information included in the document.
   d. Only that portion of the document which was audited.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

A. General Standards and Rules of Conduct
   - N85# 7 d
   - N85# 13 c
   - N85# 14 a
   - N85# 26 b
   - M88#51 c
   - M88#52 a
   - M88#53 d
   - N87#17 c
   - N87#18 b
   - N87#19 a
   - N87#22 c
   - M87#1 c
   - M87#29 b
   - N86# 1 b
   - N86# 4 b
   - N86# 6 a
   - N86#12 d
   - N86#33 d

B. Control of the Audit
   - M84# 8 d
   - M84#33 d
   - M86#16 a
   - M86#17 d
   - M86#18 b
   - M86#19 d
   - M86#22 c
   - N85# 1 c
   - N85# 2 c
   - N85# 4 b

C. Other Responsibilities
   - M84#58 a
   - M84#59 b
   - M84#60 c
   - M84#54 d
   - M85#2 a
   - M85#19 b
   - M85#20 b
   - M85#59 d
   - M84#20 c
   - N84#54 d
   - M84#40 c

II. Internal Control

A. Definitions and Basic Concepts
   - M88# 2 d
   - M87# 2 d
   - N86#13 c
   - N86#18 d
   - M86#12 c
   - M86#31 c
   - M86#32 b
   - N85# 16 c
   - N85# 37 a
   - M85# 5 b
   - M85# 7 b
   - M85#22 c
   - M85#25 b
   - M85#26 c

B. Study and Evaluation of the System
   - M84# 9 c
   - N84#16 d
   - M4# 5 c
   - M84#13 d
   - M84#24 b
   - M84#32 c
   - M86#13 c
   - M86#14 c
   - M86#25 d
   - M86#30 d
   - M85#30 c
   - M85#51 b
   - M85#52 b
   - M84#42 b

C. Cycles
   - M85# 5 a
   - M88# 9 b
   - M88#10 a
   - M87#11 d
   - M87#13 a
   - M87#20 b
   - M86#47 d
   - N87#25 c
   - N87#28 b
   - N87#29 a
   - N86# 3 b
   - N86#14 a
   - N86#15 d
   - N86#16 c
   - M86#10 b
   - M86#27 a
   - M86#28 a
   - M86#37 a
   - N85# 5 d
   - N85# 6 a
   - N85# 8 d
   - M85#19 b
   - M85#20 b
   - M85#59 d
   - N84#50 a
   - N87#48 d
   - N87#53 d
   - M87#54 b
   - N87#55 a
   - N87#56 b
   - M87#12 c
   - M87#13 b
   - M87#14 b
   - M87#15 d
   - M87#16 a
   - M87#17 b
   - M87#18 c
   - M87#20 c
   - M87#21 d
   - M87#22 d
   - N86#22 b
### Auditing

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>N86#23 b</td>
<td>M85#40 a</td>
</tr>
<tr>
<td>N86#24 c</td>
<td>M85#53 b</td>
</tr>
<tr>
<td>M86#1 b</td>
<td>M85#60 b</td>
</tr>
<tr>
<td>M86#38 c</td>
<td>N84#10 d</td>
</tr>
<tr>
<td>M86#39 c</td>
<td>N84#36 c</td>
</tr>
<tr>
<td>M86#45 a</td>
<td>N84#44 b</td>
</tr>
<tr>
<td>M86#58 b</td>
<td>N84#48 c</td>
</tr>
<tr>
<td>N85#19 c</td>
<td>M84#15 a</td>
</tr>
<tr>
<td>N85#20 a</td>
<td>M84#34 c</td>
</tr>
<tr>
<td>N85#27 c</td>
<td>M84#47 c</td>
</tr>
<tr>
<td>N85#28 c</td>
<td>M84#48 d</td>
</tr>
<tr>
<td>N85#34 c</td>
<td>M84#56 d</td>
</tr>
<tr>
<td>M85#9 a</td>
<td>M87#25 c</td>
</tr>
<tr>
<td>M85#24 b</td>
<td>M87#26 d</td>
</tr>
<tr>
<td>M85#38 c</td>
<td>N86#20 d</td>
</tr>
</tbody>
</table>

### D. Other Considerations

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>N86#27 b</td>
<td>M88#15 d</td>
</tr>
<tr>
<td>N86#31 b</td>
<td>M88#16 c</td>
</tr>
<tr>
<td>N86#32 b</td>
<td>N87#16 b</td>
</tr>
<tr>
<td>N86#33 c</td>
<td>N87#51 c</td>
</tr>
<tr>
<td>N86#34 c</td>
<td>N87#52 b</td>
</tr>
<tr>
<td>N86#35 b</td>
<td>N87#57 a</td>
</tr>
<tr>
<td>N86#36 b</td>
<td>M85#21 c</td>
</tr>
<tr>
<td>N86#37 c</td>
<td>M85#35 b</td>
</tr>
<tr>
<td>N86#38 a</td>
<td>N85#29 c</td>
</tr>
<tr>
<td>N86#39 d</td>
<td>N85#30 b</td>
</tr>
<tr>
<td>N86#40 c</td>
<td>N85#31 b</td>
</tr>
<tr>
<td>N86#41 b</td>
<td>N85#40 a</td>
</tr>
<tr>
<td>N86#42 c</td>
<td>N85#41 b</td>
</tr>
<tr>
<td>N86#43 b</td>
<td>N85#47 a</td>
</tr>
<tr>
<td>N86#44 a</td>
<td>N85#49 c</td>
</tr>
</tbody>
</table>

### III. Evidence and Procedures

#### A. Audit Evidence

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#21 a</td>
<td>M85#47 a</td>
</tr>
<tr>
<td>M88#22 b</td>
<td>M85#56 a</td>
</tr>
<tr>
<td>M88#23 c</td>
<td>N84#17 a</td>
</tr>
<tr>
<td>M88#24 c</td>
<td>N84#18 c</td>
</tr>
<tr>
<td>M88#46 a</td>
<td>N84#24 a</td>
</tr>
<tr>
<td>N87#32 a</td>
<td>N84#26 b</td>
</tr>
<tr>
<td>N87#33 c</td>
<td>N84#33 d</td>
</tr>
<tr>
<td>N87#34 b</td>
<td>N84#35 a</td>
</tr>
<tr>
<td>N87#35 b</td>
<td>N84#40 b</td>
</tr>
<tr>
<td>N87#36 d</td>
<td>N84#56 b</td>
</tr>
<tr>
<td>M87#3 d</td>
<td>M84#2 a</td>
</tr>
<tr>
<td>M87#23 d</td>
<td>M84#6 a</td>
</tr>
<tr>
<td>M87#27 c</td>
<td>M84#11 c</td>
</tr>
<tr>
<td>M87#28 a</td>
<td>M84#19 b</td>
</tr>
<tr>
<td>M87#30 d</td>
<td>M84#22 b</td>
</tr>
<tr>
<td>M87#31 b</td>
<td>M84#23 c</td>
</tr>
<tr>
<td>M87#32 a</td>
<td>M84#26 d</td>
</tr>
<tr>
<td>M87#46 c</td>
<td>M84#27 b</td>
</tr>
<tr>
<td>M86#2 a</td>
<td>M84#29 c</td>
</tr>
<tr>
<td>N86#25 c</td>
<td>M84#31 b</td>
</tr>
<tr>
<td>N86#28 a</td>
<td>M84#35 c</td>
</tr>
<tr>
<td>N86#29 b</td>
<td>M84#36 b</td>
</tr>
<tr>
<td>N86#30 d</td>
<td>M84#50 a</td>
</tr>
<tr>
<td>N86#31 c</td>
<td>M84#60 c</td>
</tr>
<tr>
<td>N86#32 c</td>
<td>M85#37 b</td>
</tr>
<tr>
<td>N86#34 a</td>
<td>M88#17 b</td>
</tr>
<tr>
<td>N86#47 a</td>
<td>N88#31 b</td>
</tr>
<tr>
<td>M86#2 c</td>
<td>M88#33 d</td>
</tr>
<tr>
<td>M86#5 d</td>
<td>M88#34 a</td>
</tr>
<tr>
<td>M86#33 b</td>
<td>M88#35 d</td>
</tr>
<tr>
<td>M86#34 c</td>
<td>M88#36 d</td>
</tr>
<tr>
<td>M86#48 c</td>
<td>M88#37 c</td>
</tr>
<tr>
<td>N85#22 d</td>
<td>M87#26 b</td>
</tr>
<tr>
<td>N85#24 a</td>
<td>M87#27 d</td>
</tr>
<tr>
<td>N85#41 b</td>
<td>M87#28 b</td>
</tr>
<tr>
<td>N85#44 a</td>
<td>M87#29 b</td>
</tr>
<tr>
<td>N85#47 d</td>
<td>M87#39 c</td>
</tr>
<tr>
<td>M85#13 c</td>
<td>N87#31 a</td>
</tr>
<tr>
<td>M85#46 d</td>
<td>N87#37 d</td>
</tr>
</tbody>
</table>

#### B. Specific Audit Objectives and Procedures

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#26 b</td>
<td>M88#27 d</td>
</tr>
<tr>
<td>M88#28 b</td>
<td>M88#29 b</td>
</tr>
<tr>
<td>M88#39 c</td>
<td>N87#31 b</td>
</tr>
<tr>
<td>N87#37 d</td>
<td>M87#33 a</td>
</tr>
<tr>
<td>M87#36 b</td>
<td>N87#38 d</td>
</tr>
<tr>
<td>M87#38 c</td>
<td>M87#39 a</td>
</tr>
</tbody>
</table>

#### C. Other Specific Audit Topics

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>N84#38 b</td>
<td>M88#17 b</td>
</tr>
<tr>
<td>N84#39 d</td>
<td>M88#31 b</td>
</tr>
<tr>
<td>M84#33 d</td>
<td>M88#33 d</td>
</tr>
<tr>
<td>M84#34 a</td>
<td>M88#34 a</td>
</tr>
<tr>
<td>M84#35 d</td>
<td>M88#35 d</td>
</tr>
<tr>
<td>M84#36 d</td>
<td>M88#37 b</td>
</tr>
<tr>
<td>M84#55 c</td>
<td>M88#38 d</td>
</tr>
<tr>
<td>N84#13 a</td>
<td>N87#38 c</td>
</tr>
</tbody>
</table>

#### D. Review and Compilation Procedures

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>M88#30 c</td>
<td>M88#40 a</td>
</tr>
<tr>
<td>M87#41 b</td>
<td>M87#45 a</td>
</tr>
<tr>
<td>M87#47 a</td>
<td>M87#48 c</td>
</tr>
<tr>
<td>M86#35 c</td>
<td>N86#35 d</td>
</tr>
<tr>
<td>N86#26 c</td>
<td>N86#36 d</td>
</tr>
<tr>
<td>N86#42 d</td>
<td>N86#40 a</td>
</tr>
<tr>
<td>N84#49 d</td>
<td></td>
</tr>
</tbody>
</table>
### IV. Reporting

<table>
<thead>
<tr>
<th>A. Reporting Standards and Types of Reports</th>
<th>M87#55 a</th>
<th>N85#53 a</th>
<th>M84#53 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>M87#57 b</td>
<td></td>
<td></td>
<td>M84#57 c</td>
</tr>
<tr>
<td>M87#58 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#25 a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#41 a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#42 b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#43 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#44 c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#45 a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#47 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#48 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88#49 a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 1 a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 2 b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 4 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 5 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 7 b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 8 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 9 c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 11 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 12 b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 13 b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N87# 40 c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87#40 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87#51 c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87#53 c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87#54 d</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B. Other Reporting Considerations</th>
<th>M88#50 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>N87# 15 c</td>
<td></td>
</tr>
<tr>
<td>N87# 30 b</td>
<td></td>
</tr>
<tr>
<td>N87# 60 c</td>
<td></td>
</tr>
<tr>
<td>M87#49 a</td>
<td></td>
</tr>
<tr>
<td>M87#56 b</td>
<td></td>
</tr>
<tr>
<td>M87#59 a</td>
<td></td>
</tr>
<tr>
<td>N86#55 a</td>
<td></td>
</tr>
<tr>
<td>N86#59 a</td>
<td></td>
</tr>
<tr>
<td>N86#60 c</td>
<td></td>
</tr>
<tr>
<td>M86#8 d</td>
<td></td>
</tr>
<tr>
<td>M86#15 a</td>
<td></td>
</tr>
<tr>
<td>M85#14 c</td>
<td></td>
</tr>
<tr>
<td>M85#42 a</td>
<td></td>
</tr>
<tr>
<td>M85#55 d</td>
<td></td>
</tr>
<tr>
<td>N84#4 b</td>
<td></td>
</tr>
<tr>
<td>N84#6 b</td>
<td></td>
</tr>
<tr>
<td>N84#7 c</td>
<td></td>
</tr>
<tr>
<td>N84#12 a</td>
<td></td>
</tr>
<tr>
<td>M84#43 d</td>
<td></td>
</tr>
<tr>
<td>M84#30 b</td>
<td></td>
</tr>
<tr>
<td>M84#42 b</td>
<td></td>
</tr>
</tbody>
</table>

A-53
ESSAYS — SELECTED QUESTIONS

I. Professional Responsibilities

M88
Number 2 (Estimated time — 15 to 25 minutes)

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:

a. Identify the types of engagements that an accountant may perform under these circumstances.

b. Explain the difference between "general use" of and "limited use" of prospective financial statements.

c. Explain what types of prospective financial statements are appropriate for "general use" and what types are appropriate for "limited use."

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

B. Study and Evaluation of the System

M86
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 respon-
possible 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.

N85

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 in their annual budget requests the types of equipment and their estimated cost. The budget, which limits the types and dollar amounts of office equipment a department head can requisition, is approved at the beginning of the year by the board of directors. Department heads prepare a purchase requisition form for equipment and forward the requisition to the purchasing department. XY’s “special” ordering system functions as follows:

Purchasing: Upon receiving a purchase requisition, one of five buyers verifies that the person requesting the equipment is a department head. The buyer then selects the appropriate vendor by searching the various vendor catalogs on file. The buyer then phones the vendor, requesting a price quotation, and gives the vendor a verbal order. A prenumbered purchase order is then processed with the original sent to the vendor, a copy to the department head, a copy to receiving, a copy to accounts payable, and a copy filed in the open requisition file. When the buyer is orally informed by the receiving department that the item has been received, the buyer transfers the purchase order from the unfilled file to the filled file. Once a month the buyer reviews the unfilled file to follow up and expedite open orders.

Receiving: The receiving department receives a copy of the purchase order. When equipment is received the receiving clerk stamps the purchase order with the date received, and, if applicable, in red pen prints any differences between quantity on the purchase order and quantity received. The receiving clerk forwards the stamped purchase order and equipment to the requisitioning department head and orally notifies the purchasing department.

Accounts payable: Upon receipt of a purchase order, the accounts payable clerk files the purchase order in the open purchase order file. When a vendor invoice is received, the invoice is matched with the applicable purchase order, and a payable is set up by debiting the equipment account of the department requesting the items. Unpaid invoices are filed by due date and, at due date, a check is prepared. The invoice and purchase order are filed by purchase order number in a paid invoice file, and then the check is forwarded to the treasurer for signature.

Treasurer: Checks received daily from the accounts payable department are sorted into two groups: those over $10,000 and those $10,000 and less. Checks for $10,000 and less are machine-signed. The cashier maintains the key and signature plate to the check-signing machine, and maintains a record of usage of the check-signing machine. All checks over $10,000 are signed by the treasurer or the controller.

Required:

Describe the internal accounting control weaknesses relating to purchases and payments of “special” orders of XY Company for each of the following functions:

a. Purchasing,
b. Receiving,
c. Accounts payable, and
d. Treasurer.
M85  Number 3 (Estimated time — — 15 to 25 minutes)

The following flowchart depicts the activities relating to the shipping, billing, and collecting processes used by Smallco Lumber, Inc.

**Required:**

Identify weaknesses in the system of internal accounting control relating to the activities of a.) warehouse clerk, b.) bookkeeper #1, c.) bookkeeper #2, and d.) collection clerk.
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?
The following flowchart depicts the activities relating to the sales, shipping, billing, and collecting processes used by Newton Hardware, Inc.

**Required:**
Identify the weaknesses in the system of internal accounting control relating to the activities of a) the warehouse clerk, b) bookkeeper A, and c) the collection clerk. Do not identify weaknesses relating to the sales clerk or bookkeepers B and C. Do not discuss recommendations concerning the correction of these weaknesses.
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.

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.
Auditing

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.

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.
Selected Questions

(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.

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.

M86
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?

B. Specific Audit Objectives and Procedures

M88
Number 3 (Estimated time — 15 to 25 minutes)

Young, CPA, is considering the procedures to be applied concerning a client's loss contingencies relating to litigation, claims, and assessments.

Required:

What substantive audit procedures should Young apply when testing for loss contingencies relating to litigation, claims, and assessments?

N87
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.

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?
Auditing

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.

N84
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.

N84
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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross apartment rents</td>
<td>$1,600,800*</td>
</tr>
<tr>
<td>Less vacancies</td>
<td>20,500*</td>
</tr>
<tr>
<td>Net apartment rentals</td>
<td>1,580,300</td>
</tr>
<tr>
<td>Less unpaid January rents</td>
<td>7,800*</td>
</tr>
<tr>
<td>Total</td>
<td>1,572,500</td>
</tr>
<tr>
<td>Add prepaid rent collected (Apartment 116)</td>
<td>500*</td>
</tr>
<tr>
<td>Total cash collected</td>
<td>$1,573,000*</td>
</tr>
</tbody>
</table>

Schedules A, B, and C are available to Finney but have not been illustrated. Finney has conducted a study and evaluation of the system of internal control and found that it could be relied upon to produce reliable accounting information. Cash receipts from rental operations are deposited in a special bank account.

Required:

What substantive audit procedures should Finney employ during the audit in order to substantiate the validity of each of the dollar amounts marked by an asterisk (*)?

C. Other Specific Audit Topics

N87
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.

N87
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:
Selected Questions

Smith plans to use sampling to obtain substantive evidence 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.

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.
Auditing

IV. Reporting

In April 1988, the Auditing Standards Board issued *Statement on Auditing Standards No. 58*, "Reports on Audited Financial Statements," superseding SAS No. 2, "Reports on Audited Financial Statements" (1974). Accordingly, all previous examination items covered by SAS No. 2 have been deleted.

A. Reporting Standards and Types of Reports

M88
Number 2 (Estimated time — — 15 to 25 minutes)

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:

b. Describe the contents of the accountant's standard report on a compilation of a financial projection.

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.

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-66
I. Professional Responsibilities

M88
Answer 2 (10 points)

a. 1. An accountant who reports on or assembles prospective financial statements for use by third parties should perform any one of three engagements. The accountant may compile, examine, or apply agreed-upon procedures to the prospective financial statements.

2. "General use" of prospective financial statements refers to use of the statements by persons (creditors, stockholders, etc.) with whom the responsible party (management) is not negotiating directly. "Limited use" of prospective financial statements refers to the use of prospective financial statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly.

3. Only a financial forecast is appropriate for general use, but any type of prospective financial statements (either a financial forecast or a financial projection) would normally be appropriate for limited use.

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.


**Auditing**

- Arrangements with respect to client assistance in the performance of the audit engagement.
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- Notification of any changes in the original arrangements that might be necessitated by unknown or unforeseen factors.

- Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
- The basis on which fees are computed and any billing arrangements.

**II. Internal Control**

**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.

**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.
Unofficial Answers

- 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 of journals, that is, sales and cash receipts journals.
- Subsidiary accounts receivable ledger should be reconciled to general ledger.

Collection Clerk

- Collection clerk should not maintain sales journal.
- Collection clerk should not maintain accounts receivable subsidiary ledger.
- Remittance advice not used as the basis for posting collections.
- Checks are not promptly endorsed by the mail clerk.
- Cash receipts are not promptly deposited.
- Deposit slips are not reconciled to cash receipts journal or debits to general ledger.

M84
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?
- 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?
Auditing

C. Cycles

Answer 4 (10 points)

The weaknesses in Newton Hardware's internal accounting controls include these:

Warehouse Clerk

- Initiates posting to inventory records by preparation of shipping advice.
- Releases merchandise to customers before proper approvals of customers' credit.
- Does not retain a copy of the shipping advice for comparison with receipt from carrier.

Bookkeeper A

- Authorizes customers' credit and prepares source documents for posting to customers' accounts.
- Prepares invoices without notice that the merchandise was actually shipped and the date it was shipped.
- Authorizes write-offs of customer accounts receivable and authorizes customers' credit.

Collection Clerk

- Receives directly and records customers' checks.
- Does not deliver checks excluded from the deposit to an employee independent of the bank deposit for review and disposition.
- Initiates posting of receipts to subsidiary accounts receivable ledger and has initial access to cash receipts.
- Does not deposit cash receipts promptly.
- Reconciles bank statement and has initial access to cash receipts.

Answer 2 (10 points)

STAR MANUFACTURING, INC.

Purchases

Internal Accounting Control Questionnaire

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Are there written purchasing policies and procedures?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>2. Are purchase requisitions approved in accordance with management's authorization?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>3. Are purchases made from approved vendors?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>4. Are price quotations requested for purchases over an established amount?</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

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>Are customers who pay by check identified via store I.D. card or other means?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does company policy prohibit accepting checks for anything except merchandise sales plus a nominal cash amount?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is a receipt produced by the cash register given to each customer?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the reading of each cash register taken periodically by an employee who is independent of the handling of cash receipts?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are cash counts made on a surprise basis by an individual who is independent of the handling of cash receipts?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the reading of each cash register compared regularly to the cash received?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Unofficial Answers

Is a summary listing of cash register readings prepared by an employee who is independent of physically handling cash receipts?

Yes:  
No:

Are receipts forwarded to an independent employee who makes the bank deposits?

Yes:
No:

Are each day's receipts deposited intact daily?

Yes:
No:

Is the summary listing of cash register receipts reconciled to the duplicate deposit slips authenticated by the bank?

Yes:
No:

Are entries to the cash receipts journal prepared from duplicate deposit slips or the summary listing of cash register readings?

Yes:
No:

Are the entries to the cash receipts journal compared to the deposits per bank statement?

Yes:
No:

Are areas involving the physical handling of cash reasonably safeguarded?

Yes:
No:

Are employees who handle receipts bonded?

Yes:
No:

Are charged back items (NSF checks, etc.) directed to an employee who does not physically handle receipts or have access to the books?

Yes:
No:

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

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.
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.

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 recog-

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.
izes 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.

M85

Answer 4 (10 points)

a. Evidence found in the working papers to support the fact that the audit was adequately planned and assistants were properly supervised would be

- Documentation indicating discussions with client personnel concerning developments affecting the entity that require recognition in the audit plan.
- Documentation of a preaudit planning conference among audit firm personnel to develop an audit strategy by considering matters noted in the review of prior years' working papers, changes in accounting and auditing standards, etc.
- An internal control writeup documenting that the system of internal accounting control had been reviewed.
- Audit programs tailored to the strengths and weaknesses of the internal accounting control system.
- Audit programs indicating steps that were assigned to and completed by individual assistants.
- A budget indicating the time to be spent in each audit area.
- Individual working papers signed by reviewers to document review, approval, and responsibility.
- All questions raised by assistants were answered.

b. Substantive tests which would document management's completeness assertion as it relates to inventory quantities would be

- Observation of physical inventory counts.
- Analytical review of the relationship of inventory balances to purchase, production, and sales activities.
- Inspection of shipping and receiving documentation for proper amounts and dates to verify proper cutoff procedures.
- Obtaining confirmation of inventories at locations outside the entity.
The substantive audit procedures that Young should apply when testing for loss contingencies relating to litigation, claims, and assessments include the following:

- Read minutes of meetings of stockholders, directors, and committees.
- Read contracts, loan agreements, leases, and other documents.
- Read correspondence with taxing and other governmental agencies.
- Read correspondence with insurance and bonding companies.
- Read confirmation replies for information concerning guarantees.
- Discuss with management the entity's policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management or inside counsel a description and evaluation of litigation, claims, and assessments.
- Obtain written assurance from management that the financial statements include all accruals and disclosures required by Statement on Financial Accounting Standards No. 5.
- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence from lawyers.
- Obtain an analysis of professional fees and expenses and review supporting invoices for indications of contingencies.
- Request the client's management to prepare for transmittal a letter of inquiry to those lawyers consulted by the client concerning litigation, claims, and assessments.
- Compare the lawyer's response to the items in the letter of inquiry to the description and evaluation of litigation, claims, and assessments obtained from management.
- Determine that the financial statements include proper accruals and disclosures of the contingencies.

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.
\textit{Unofficial Answers}

- 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.
- 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.

dation, 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

\textbf{N85}

\textbf{Answer 2 (10 points)}

\textbf{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 conso-
M84

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

**N87 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.
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 = \( \frac{\text{Tolerable Error}}{\text{Reliability Factor for Errors of Overstatement}} \)

\[
= \frac{\$15,000}{3.00} = \$5,000
\]

Sample Size = \( \frac{\text{Recorded Amount}}{\text{Sampling Interval}} \)

\[
= \frac{\$300,000}{\$5,000} = 60
\]

c. 

<table>
<thead>
<tr>
<th>Recorded Amount</th>
<th>Audit Amount</th>
<th>Tainting</th>
<th>Sampling Interval</th>
<th>Projected Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st error</td>
<td>$400</td>
<td>$320</td>
<td>20%</td>
<td>$1,000</td>
</tr>
<tr>
<td>2nd error</td>
<td>500</td>
<td>0</td>
<td>100%</td>
<td>1,000</td>
</tr>
<tr>
<td>3rd error</td>
<td>3,000</td>
<td>2,500</td>
<td>*</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Total Projected Error = $1,700

* The recorded amount is greater than the sampling interval; therefore, the projected error equals the actual error.

d. Expected amount of error.

e. Population size.

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.
IV. Reporting

A. Reporting Standards and Types of Reports

**M88**

**Answer 2 (10 points)**

b. The accountant's standard report on a compilation of a financial projection should include

- An identification of the projection presented by the responsible party.
- A statement that the accountant has compiled the projection in accordance with standards established by the AICPA.
- A separate paragraph that describes the limitations on the use of the presentation.
- A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the projection or the assumptions.
- A caveat that the prospective results may not be achieved.
- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

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.

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.
Uniform CPA Examination/May 1984 – May 1988

Business Law

Selected Questions And Unofficial Answers Indexed To Content Specification Outline
TABLE OF CONTENTS

Selected Questions

I. The CPA and the Law
   A. Common Law Liability to Clients and Third Persons  B-1  B-67†
   B. Federal Statutory Liability  B-3
   C. Workpapers, Privileged Communication, and Confidentiality  B-4

II. Business Organizations
   A. Agency  B-5
   B. Partnerships and Joint Ventures  B-8  B-69
   C. Corporations  B-10  B-70
   D. Estates and Trusts  B-13  B-72

III. Contracts
   A. Offer and Acceptance  B-14
   B. Consideration  B-16
   C. Capacity, Legality, and Public Policy  B-17
   D. Statute of Frauds  B-18
   E. Statute of Limitations  B-19
   F. Fraud, Duress, and Undue Influence  B-20
   G. Mistake and Misrepresentation  B-21
   H. Parol Evidence Rule  B-22
   I. Third Party Rights  B-23
   J. Assignments  B-24
   K. Discharge, Breach, and Remedies  B-24

IV. Debtor-Creditor Relationships
   A. Suretyship  B-26
   B. Bankruptcy  B-28

V. Government Regulation of Business
   A. Regulation of Employment  B-32  *
   B. Federal Securities Acts  B-35  B-76

VI. Uniform Commercial Code
   A. Commercial Paper  B-40  B-76
   B. Documents of Title and Investment Securities  B-47  *
   C. Sales  B-48  B-77
   D. Secured Transactions  B-52  B-79

* No essays were indexed for this group.
† Questions in this area are not classified according to group.

B-iii
Selected Questions

VII. Property
   A. Real and Personal Property
   B. Mortgages
   C. Fire and Casualty Insurance

Selected Multiple Choice Items — Unofficial Answers
   B-63

Essays — Selected Questions
   B-67

Selected Essays — Unofficial Answers
   B-83

November 1988 Uniform CPA Examination Questions & Unofficial Answers
   N-1

Suggested References
   N-76

Index
   N-81

Content Specification Outlines
   CSO-1
MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons

M88

Items 1 and 2 are based on the following information:

Mead Corp. orally engaged Dex & Co., CPAs, to audit its financial statements. The management of Mead informed Dex that it suspected that the accounts receivable were materially overstated. Although the financial statements audited by Dex did, in fact, include a materially overstated accounts receivable balance, Dex issued an unqualified opinion. Mead relied on the financial statements in deciding to obtain a loan from City Bank to expand its operations. City relied on the financial statements in making the loan to Mead. As a result of the overstated accounts receivable balance, Mead has defaulted on the loan and has incurred a substantial loss.

1. If Mead sues Dex for negligence in failing to discover the overstatement, Dex's best defense would be that
   a. No engagement letter had been signed by Dex.
   b. The audit was performed by Dex in accordance with generally accepted auditing standards.
   c. Dex was not in privity of contract with Mead.
   d. Dex did not perform the audit recklessly or with an intent to deceive.

2. If City sues Dex for fraud, Dex would most likely avoid liability if it could prove that
   a. Dex was not in privity of contract with City.
   b. Dex did not perform the audit recklessly or with an intent to deceive.
   c. Mead should have provided more specific information concerning its suspicions.
   d. Mead was contributorily negligent.

M87

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 the 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.

M87#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.

M87#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>

B-1
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.

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.

In which of the following statements concerning a CPA firm’s action is sciente 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 monarily by concealing fraud.

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.

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.

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.

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.

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.

Dexter and Co., CPAs, issued an unqualified opinion on the 1983 financial statements of Bart Corp. Late in 1984, Bart determined that its treasurer had embezzled over $1,000,000. Dexter was unaware of the embezzlement. Bart has decided to sue Dexter to recover the $1,000,000. Bart’s suit is based upon Dexter’s failure to discover the missing money while performing the audit. Which of the following is Dexter’s best defense?
   a. That the audit was performed in accordance with GAAS.
   b. Dexter had no knowledge of the embezzlement.
   c. The financial statements were presented in conformity with GAAP.
   d. The treasurer was Bart’s agent and as such had designed the internal controls which facilitated the embezzlement.
N84#7. If a stockholder sues a CPA for common law fraud based upon false statements contained in the financial statements audited by the CPA, which of the following is the CPA’s best defense?
   a. The stockholder lacks privity to sue.
   b. The CPA disclaimed liability to all third parties in the engagement letter.
   c. The contributory negligence of the client.
   d. The false statements were immaterial.

B. Federal Statutory Liability

M88#8. West & Co., CPAs, was engaged by Sand Corp. to audit its financial statements. West issued an unqualified opinion on Sand’s financial statements. Sand has been accused of making negligent misrepresentations in the financial statements, which Reed relied upon when purchasing Sand stock. West was not aware of the misrepresentations nor was it negligent in performing the audit. If Reed sues West for damages based upon Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, West will
   a. Lose, because Reed relied upon the financial statements.
   b. Lose, because the statements contained negligent misrepresentations.
   c. Prevail, because some element of scienter must be proved.
   d. Prevail, because Reed was not in privity of contract with West.

M88#9. In general, if the IRS issues a 30-day letter to an individual taxpayer who wishes to dispute the assessment, the taxpayer
   a. May, without paying any tax, immediately file a petition that would properly commence an action in Tax Court.
   b. May ignore the 30-day letter and wait to receive a 90-day letter.
   c. Must file a written protest within 10 days of receiving the letter.
   d. Must pay the taxes and then commence an action in federal district court.

N87

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.

N87#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.

N87#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 will
   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.

N86#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.

86#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.

84#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.

84#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>
<thead>
<tr>
<th>Damages</th>
<th>Materiality of the misstatement</th>
<th>Kosson’s scienter</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

84#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.

84#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.

C. Workpapers, Privileged Communication, and Confidentiality

88

Item 3 is based on the following information:

Mead Corp. orally engaged Dex & Co., CPAs, to audit its financial statements. The management of Mead informed Dex that it suspected that the accounts receivable were materially overstated. Although the financial statements audited by Dex did, in fact, include a materially overstated accounts receivable balance, Dex issued an unqualified opinion. Mead relied on the financial statements in deciding to obtain a loan from City Bank to expand its operations. City relied on the financial statements in making the loan to Mead. As a result of the overstated accounts receivable balance, Mead has defaulted on the loan and has incurred a substantial loss.

3. If City sues Dex for fraud, could Dex be compelled to furnish City with the audit working papers?

a. No, because of the privileged communication rule, which is recognized in a majority of jurisdictions.
b. No, because City was not in privity of contract with Dex.
c. Yes, if the working papers are relevant to the action.
d. Yes, provided that Mead does not object.
Selected Questions

N87#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.

N86#9. 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.

N86#10. 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.

N84#8. The accountant-client privilege
   a. May not be waived by either the accountant or the client.
   b. Is intended to protect full and honest disclosure between accountant and client.
   c. Is as widely recognized as the attorney-client privilege.
   d. Only applies to written documents.

II. Business Organizations

A. Agency

N88

Items 4 and 5 are based on the following information:

Able, on behalf of Pix Corp., entered into a contract with Sky Corp., by which Sky agreed to sell computer equipment to Pix. Able disclosed to Sky that she was acting on behalf of Pix. However, Able had exceeded her actual authority by entering into the contract with Sky.

4. If Pix does not want to honor the contract, it will nonetheless be held liable if Sky can prove that
   a. Able had apparent authority to bind Pix.
   b. Able believed she was acting within the scope of her authority.
   c. Able was an employee of Pix and not an independent contractor.
   d. The agency relationship between Pix and Able was formalized in a signed writing.

5. If Pix wishes to ratify the contract with Sky, which of the following statements is correct?
   a. Pix must notify Sky that Pix intends to ratify the contract.
   b. Able must have acted reasonably and in Pix's best interest.
   c. Able must be a general agent of Pix.
   d. Pix must have knowledge of all material facts relating to the contract at the time it is ratified.

M88#6. The apparent authority of a general agent for a disclosed principal will terminate without notice to third parties when the
   a. Principal dismisses the agent.
   b. Principal or agent dies.
   c. Purpose of the agency relationship has been fulfilled.
   d. Time period set forth in the agency agreement has expired.

N87

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.

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.

M87#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.

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 respondent 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 Corp. It is understood 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 en-
gaging 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. 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.

M84#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.

B. Partnerships and Joint Ventures

M88#7. Dill was properly admitted as a partner in the ABC Partnership after purchasing Ard’s partnership interest. Ard immediately withdrew from the partnership. The partnership agreement states that the partnership will continue on the withdrawal or admission of a partner. Unless the partners otherwise agree,

a. Dill’s personal liability for partnership debts incurred before Dill was admitted will be limited to Dill’s interest in partnership property.
b. Ard will automatically be released from personal liability for partnership debts incurred before Dill’s admission.
c. Ard will be permitted to recover from the other partners the full amount that Ard has paid on account of partnership debts incurred before Dill’s admission.
d. Dill will be subjected to unlimited personal liability for partnership debts incurred before being admitted.

M88#13. X, Y, and Z have capital balances of $30,000, $15,000, and $5,000, respectively, in the XYZ Partnership. The general partnership agreement is silent as to the manner in which partnership losses are to be allocated but does provide that partnership profits are to be allocated as follows: 40% to X, 25% to Y, and 35% to Z. The partners have decided to dissolve and liquidate the partnership. After paying all creditors, the amount available for distribution will be $20,000. X, Y, and Z are individually solvent. Under the circumstances, Z will

a. Receive $7,000.
b. Receive $12,000.
c. Personally have to contribute an additional $5,500.
d. Personally have to contribute an additional $5,000.

M88#14. Grey and Carr entered into a written partnership agreement to operate a hardware store. Their agreement was silent as to the duration of the partnership. Grey wishes to dissolve the partnership. Which of the following statements is correct?

a. Unless Carr consents to a dissolution, Grey must apply to a court and obtain a decree ordering the dissolution.
b. Grey may not dissolve the partnership unless Carr consents.
c. Grey may dissolve the partnership only after notice of the proposed dissolution is given to all partnership creditors.
d. Grey may dissolve the partnership at any time.

N87#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.

N87#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.

N87#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.

N87#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.
Selected Questions

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.

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 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/#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 prior to her admission as a partner.
   d. Limit White’s liability on partnership debts arising prior to her admission as a partner to her interest in partnership property.

M85#9. Unless otherwise provided for, the assignment of a partnership interest will result in the
   a. Dissolution of the partnership.
   b. Assignee obtaining the right to receive the share of the profits to which the assignor would have otherwise been entitled.
   c. Assignee succeeding to the assignor’s rights to participate in the management of the partnership.
   d. Vesting of the assignor’s right to inspect the partnership books in the assignee.

M85#10. Long, Pine, and Rice originally contributed $100,000, $60,000, and $20,000, respectively, to form the LPR Partnership. Profits and losses of LPR are to be distributed ½ to Long, ½ to Pine, and ¼ 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

C. Corporations

M88#15. In general, which of the following statements concerning treasury stock is correct?
   a. A corporation may not reacquire its own stock unless specifically authorized by its articles of incorporation.
b. On issuance of new stock, a corporation has preemptive rights with regard to its treasury stock.

c. Treasury stock may be distributed as a stock dividend.

d. A corporation is entitled to receive cash dividends on its treasury stock.

**M87#1.** 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.

**M87#2.** 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.

**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.

**M85#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.

Jane Cox, a shareholder of Mix Corp., has properly commenced a derivative action against Mix’s Board of Directors. Cox alleges that the Board breached its fiduciary duty and was negligent by failing to independently verify the financial statements prepared by management upon which Smart & Co., CPAs, issued an unqualified opinion. The financial statements contained inaccurate information which the Board relied upon in committing large sums of money to capital expansion. This resulted in Mix having to borrow money at extremely high interest rates to meet current cash needs. Within a short period of time, the price of Mix Corp. stock declined drastically.

3. Which of the following statements is correct?
   a. The Board is strictly liable, regardless of fault, since it owes a fiduciary duty to both the corporation and the shareholders.
   b. The Board is liable since any negligence of Smart is automatically imputed to the Board.
   c. The Board may avoid liability if it acted in good faith and in a reasonable manner.
   d. The Board may avoid liability in all cases where it can show that it lacked scienter.

4. If the court determines that the Board was negligent and the Board seeks indemnification for its legal fees from Mix, which of the following statements is correct?
   a. The Board may not be indemnified since a presumption that the Board failed to act in good faith arises from the judgment.
   b. The Board may not be indemnified unless Mix’s shareholders approve such indemnification.
   c. The Board may be indemnified by Mix only if Mix provides liability insurance for its officers and directors.
   d. The Board may be indemnified by Mix only if the court deems it proper.

**M85#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.

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.

M84#6. Which of the following would be grounds for the judicial dissolution of a corporation on the petition of a shareholder?
   a. Refusal of the board of directors to declare a dividend.
   b. Waste of corporate assets by the board of directors.
   c. Loss operations of the corporation for three years.
   d. Failure by the corporation to file its federal income tax returns.

M84#7. Able and Baker are two corporations, the shares of which are publicly traded. Baker plans to merge into Able. Which of the following is a requirement of the merger?
   a. The IRS must approve the merger.
   b. The common stockholders of Baker must receive common stock of Able.
   c. The creditors of Baker must approve the merger.
   d. The boards of directors of both Able and Baker must approve the merger.

M84#8. For which of the following reasons would the corporate veil most likely be pierced and the shareholders held personally liable?
   a. The corporation is a personal holding company.
   b. The corporation was organized because the shareholders wanted to limit their personal liability.
   c. The corporation and its shareholders do maintain separate bank accounts and records.
   d. The corporation’s sole shareholder is another domestic corporation.

M84#9. Which of the following statements concerning treasury stock is correct?
   a. Cash dividends paid on treasury stock are transferred to stated capital.
   b. A corporation may not purchase its own stock unless specifically authorized by its articles of incorporation.
   c. A duly appointed trustee may vote treasury stock at a properly called shareholders’ meeting.
   d. Treasury stock may be resold at a price less than par value.

M84#10. Generally, articles of incorporation must contain all of the following except the
   a. Names of the incorporators.
   b. Name of the corporation.
   c. Number of shares authorized.
   d. Names of initial officers and their terms of office.
D. Estates and Trusts

**M88#10.** To create a valid inter vivos trust to hold personal property, the trust must be:
   a. In writing and signed by the settlor (creator).
   b. Specific concerning the property to be held in trust.
   c. Irrevocable.
   d. In writing and signed by the trustee.

**M88**  
**Items 11 and 12** are based on the following information:

Rusk properly created an inter vivos trust naming Gold as the trustee. The sole asset of the trust is an office building that is fully rented. Rental receipts exceed expenditures. The trust instrument is silent as to the allocation of items between principal and income.

11. Among the items to be allocated by Gold during the year are insurance proceeds received as a result of fire damage to the building and the mortgage interest payments made during the year. Which of the following items is properly allocable to principal?

<table>
<thead>
<tr>
<th>Insurance proceeds</th>
<th>Current mortgage interest payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>on building</td>
<td></td>
</tr>
<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>

12. Which of the following statements is correct concerning Gold's responsibility as trustee?
   a. Gold's duty of loyalty will be breached by Gold's purchasing assets from the trust despite a provision in the trust agreement permitting such a purchase.
   b. Gold owes a duty of loyalty to the trust but not to the beneficiaries.
   c. Gold must exercise reasonable care and skill while performing the duties of a trustee.
   d. Gold will be free from personal liability with regard to all contracts entered into by Gold on behalf of the trust absent fraud by Gold.

**N87**  
**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.

**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>
Business Law

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.

M86#54. Okun, a major shareholder in Stalc 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.

III. Contracts

A. Offer and Acceptance

M88#16. In order for an offer to confer the power to form a contract by acceptance, it must have all of the following elements except
   a. Be communicated to the offeree and the communication must be made or authorized by the offeror.
   b. Be sufficiently definite and certain.
   c. Be communicated by words to the offeree by the offeror.
   d. Manifest an intent to enter into a contract.

M88#17. On July 1, Silk, Inc., sent Blue a telegram offering to sell Blue a building for $80,000. In the telegram, Silk stated that it would give Blue 30 days to accept the offer. On July 15, Blue sent Silk a telegram that included the following statement: "The price for your building seems too high. Would you consider taking $75,000?" This telegram was received by Silk on July 16. On July 19, Tint made an offer to Silk to purchase the building for $82,000. Upon learning of Tint's offer, Blue, on July 27, sent Silk a signed letter agreeing to purchase the building for $80,000. This letter was received by Silk on July 29. However, Silk now refuses to sell Blue the building. If Blue commences an action against Silk for breach of contract, Blue will
   a. Win, because Blue effectively accepted Silk's offer of July 1.
   b. Win, because Silk was obligated to keep the offer open for the 30-day period.
   c. Lose, because Blue sent the July 15 telegram.
   d. Lose, because Blue used an unauthorized means of communication.

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.
Selected Questions

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. Carr’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.

N86#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.

N86#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.

**M85#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 Item 21** is 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#18.** The following conversation took place between Mary and Ed. Mary: "Ed, if you wanted to sell your table, what would you ask for it?" Ed: "I suppose $400 would be a fair price." Mary: "I'll take it, if you will have it refinished." Ed: "Sold." Thus

a. Ed's statement: "I suppose $400 would be a fair price" constituted an offer.
b. Mary's reply: "I'll take it, if you will have it refinished" was a conditional acceptance, terminating Ed's offer.
c. No contract resulted since Ed never stated he would actually sell the table for $400.
d. A contract was formed when Ed said: "Sold."

**N84#19.** On January 1, Lemon wrote Martin offering to sell Martin his ranch for $80,000 cash. Lemon's letter indicated that the offer would remain open until February 15 if Martin mailed $100 by January 10. On January 5, Martin mailed $100 to Lemon. On January 30, Martin telephoned Lemon stating that he would be willing to pay $60,000 for the ranch. Lemon refused to sell at that price and immediately placed the ranch on the open market. On February 6, Martin mailed Lemon a letter accepting the original offer to buy the ranch at $80,000. The following day, Lemon received Martin's acceptance. At that time the ranch was on the market for $100,000. Which of the following is correct?

a. Martin's mailing of $100 to Lemon on January 5 failed to create an option.
b. Martin's communication of January 30 automatically terminated Lemon's offer of January 1.
c. The placing of the ranch on the market by Lemon constituted an effective revocation of his offer of January 1.
d. Martin's letter of February 6 formed a binding contract based on the original terms of Lemon's January 1 letter.

**B. Consideration**

**M86#18.** In deciding whether consideration necessary to form a contract exists, a court must determine whether

a. The consideration given by each party is of roughly equal value.
b. There is mutuality of consideration.
c. The consideration has sufficient monetary value.
d. The consideration conforms to the subjective intent of the parties.
Selected Questions

M87#12. 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.

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.

M85#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.

C. Capacity, Legality, and Public Policy

M88#19. Parr is a CPA licensed to practice in State A. Parr entered into a contract with Jet, Inc., to perform an audit in State B for $50,000 (including expenses). After Parr had satisfactorily performed the audit, Jet discovered that Parr had violated State B's licensing statute by failing to obtain a CPA license in State B. Parr incurred $10,000 in expenses in connection with the audit. Jet refuses to pay any fee to Parr, arguing that it could have engaged a local CPA licensed in State B to perform the same services for $35,000 (including expenses). If Parr sues Jet based on breach of contract, Parr will be entitled to recover a maximum of
   a. $0.
   b. $10,000.
   c. $35,000.
   d. $50,000.

M87#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.

B-17
**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.

**M86#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.

**M86#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

**M86#4.** On May 1, 1985, Mint, a 16-year old, purchased a sail boat 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.

**M86#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.

**M84#20.** Aqua, Inc., a Florida corporation, entered into a contract for $30,000 with Sing, Inc., to perform plumbing services in a complex owned by Sing in Virginia. After the work was satisfactorily completed, Sing discovered that Aqua violated Virginia’s licensing law by failing to obtain a plumbing license. Virginia’s licensing statute was regulatory in nature, serving to protect the public against unskilled and dishonest plumbers. Upon Sing’s request, independent appraisals of Aqua’s work were performed, which indicated that the complex was benefited to the extent of $25,000. Sing refuses to pay Aqua. If Aqua brings suit it may recover
   a. $30,000.
   b. $25,000.
   c. Nothing.
   d. An amount sufficient to cover its out-of-pocket costs.

**M84#11.** Mix entered into a contract with Small which provided that Small would receive $10,000 if he stole trade secrets from Mix’s competition. Small performed his part of the contract by delivering the trade secrets to Mix. Mix refuses to pay Small for his services. Under what theory may Small recover?
   a. Quasi contract, in order to prevent the unjust enrichment of Mix.
   b. Promissory estoppel, since Small has changed his position to his detriment.
   c. None, due to the illegal nature of the contract.
   d. Express contract, since both parties bargained for and exchanged promises in forming the contract.

**D. Statute of Frauds**

**M88#20.** On May 1, Dix and Wilk entered into an oral agreement by which Dix agreed to purchase a small parcel of land from Wilk for $450. Dix paid Wilk $100
as a deposit. The following day, Wilk received another offer to purchase the land for $650, the fair market value. Wilk immediately notified Dix that Wilk would not sell the land for $450. If Dix sues Wilk for specific performance, Dix will

a. Prevail, because the amount of the contract was less than $500.

b. Prevail, because there was part performance.

c. Lose, because the fair market value of the land is over $500.

d. Lose, because the agreement was not in writing and signed by Wilk.

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.

M86#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.

E. Statute of Limitations

M88#22. On May 1, 1972, Mix, CPA, entered into an oral contract with Dell to provide certain accounting services to Dell. The contract was fully performed by both parties in 1974. On April 25, 1988, Dell commenced a breach of contract action against Mix claiming that Mix had improperly performed the accounting services. Mix's best defense to the action would likely be the

a. Parol evidence rule.

b. Statute of limitations.

c. Statute of frauds.

d. Lack of consideration.

N85#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.

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

M88#25. To establish a cause of action based on fraud in the inducement, one of the elements the plaintiff must generally prove is that

a. It is impossible for the plaintiff to perform the terms of the contract.
b. The contract is unconscionable.
c. The defendant made a false representation of a material fact.
d. There has been a mutual mistake of a material fact by the plaintiff and defendant.

M87#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.

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.

N86

Items 19 through 20 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.
Selected Questions

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.

M85#10. One of the elements necessary to establish fraud is that
   a. There was a written misrepresentation of fact.
   b. The defendant was in a position of trust and confidence with respect to the plaintiff.
   c. The defendant made a false statement with actual or constructive knowledge of its falsity.
   d. The plaintiff was induced to enter into a contract as the result of an improper threat by the defendant.

M85#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.

G. Mistake and Misrepresentation

M87#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.

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.
Item 21 is 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 $50,000 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.

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.

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.

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.

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.

H. Parol Evidence Rule

Baker and Able signed a contract which required Able to purchase 600 books from Baker at 90¢ per book. Subsequently, Able, in good faith, requested that the price of the books be reduced to 80¢ per book. Baker orally agreed to reduce the price to 80¢. Under the circumstances, the oral agreement is
   a. Unenforceable, because Able failed to give consideration, but proof of it will be otherwise admissible into evidence.
   b. Unenforceable, due to the statute of frauds, and proof of it will be inadmissible into evidence.
   c. Enforceable, but proof of it will be inadmissible into evidence.
   d. Enforceable, and proof of it will be admissible into evidence.

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.
Selected Questions

N85#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.

N85#25. Where the parties have entered into a written contract intended as the final expression of their agreement, the parol evidence rule generally prevents the admission into evidence of any:
   a. Other written agreement which is referred to in the contract.
   b. Contemporaneous oral agreement which explains an ambiguity in the written contract.
   c. Prior oral or written agreement and any contemporaneous oral agreement which contradict the terms of the written contract.
   d. Subsequent oral modification of the contract.

N84#23. Fred entered into a written contract with Joe to purchase a car. The written contract was intended to be the final and complete agreement of the parties. Fred is unhappy with the performance of the car and has commenced an action for breach of contract based on an oral representation made at the time the written contract was executed. Fred may introduce evidence of the representation if it:
   a. Completely modifies the written contract.
   b. Contradicts the written agreement.
   c. Serves to clarify an ambiguous term in the written contract.
   d. Falls within the provisions of the Statute of Frauds.

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, the building with the mortgage.
   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.

N86#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

Item 17 is based on the following information:

Sand sold a warehouse he owned to Quick Corp. The warehouse was encumbered by an outstanding mortgage securing Sand's note to Security Bank. Quick assumed the Sand's note and mortgage at the time it purchased the warehouse from Sand. Within three months, Quick defaulted on the note and Security Bank commenced a mortgage foreclosure action. The proceeds of the resulting foreclosure sale were less than the outstanding balance on the note.

17. As to the contract between Sand and Quick, Security is
   a. A third party creditor beneficiary.
   b. A third party donee beneficiary.
   c. A third party incidental beneficiary.
   d. Not a beneficiary.

M85#26. Fink is the owner of a parcel of land which is encumbered by a mortgage securing Fink's note to State Bank. Fink sold the land to Bloom who assumed the mortgage note. State Bank
   a. Is a donee beneficiary.
   b. Is an incidental beneficiary.
   c. Is a creditor beneficiary.
   d. Can not collect from Fink if Bloom defaults.
N84#25. Red purchased a life insurance policy from Ace Insurance Co. naming his wife Bertha as the sole beneficiary. In order for Bertha to qualify as a donee beneficiary she must
   a. Have had knowledge of the insurance contract at the time the contract was entered into.
   b. Be in privity of contract with Ace.
   c. Have provided consideration.
   d. Have been the person intended to be benefited from the life insurance contract.

J. Assignments

M88#23. Quick Corp. has $270,000 of outstanding accounts receivable. On March 10, 1988, Quick assigned a $30,000 account receivable due from Pine, one of Quick's customers, to Taft Bank for value. On March 30, Pine paid Quick the $30,000. On April 5, Taft notified Pine of the March 10 assignment from Quick to Taft. Taft is entitled to collect $30,000 from
   a. Either Quick or Pine.
   b. Neither Quick nor Pine.
   c. Pine only.
   d. Quick only.

M87#21. On May 2, Kurtz Co. assigned its entire interest 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 informed 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 frauds does not apply to the proposed contract.

M85#5. On May 1, Apple mailed a signed offer to sell an office building to Fein for $90,000. The offer indicated that it would remain open until May 10. On May 5, Fein assigned the offer to Boyd for $5,000. On May 8, Boyd orally accepted Apple's offer. Apple refused to sell the building to Boyd. Which of the following statements is correct?
   a. Fein's assignment to Boyd was effective because an option contract was formed between Apple and Fein on May 1.
   b. Fein's assignment to Boyd was effective against Apple because valid consideration was given.
   c. Boyd's acceptance was ineffective because the offer could not be assigned.
   d. Boyd's acceptance was ineffective against Apple because it was oral.

M85

Item 22 is 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.

K. Discharge, Breach, and Remedies

M88#24. Dell owed Stark $9,000. As the result of an unrelated transaction, Stark owed Ball that same amount. The three parties signed an agreement that Dell would pay Ball instead of Stark, and Stark would be discharged from all liability. The agreement among the parties is
   a. A novation.
   b. An executed accord and satisfaction.
   c. Voidable at Ball's option.
   d. Unenforceable for lack of consideration.

N87#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.

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#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.

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 the 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.

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
Item 18 is 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.

**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.

**M84#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.

**IV. Debtor-Creditor Relationships**

**A. Suretyship**

**M86#26.** Sklar borrowed $360,000 from Rich Bank. At Rich’s request, Sklar entered into an agreement with Aker, Burke, and Cey to act as co-sureties on the loan. The agreement between Sklar and the co-sureties provided that the maximum liability of each co-surety was: Aker $72,000, Burke $108,000, and Cey $180,000. After making several payments, Sklar defaulted on the loan. The balance was $240,000. If Cey pays $180,000 and Sklar subsequently pays $60,000, what amounts may Cey recover from Aker and Burke?
   a. $0 from Aker and $0 from Burke.
   b. $60,000 from Aker and $60,000 from Burke.
   c. $48,000 from Aker and $72,000 from Burke.
   d. $36,000 from Aker and $54,000 from Burke.

**M86#27.** Lux Financial Corp. loaned Boe $100,000. At Lux’s request, Boe entered into an agreement with Frey and Harp for them to act as co-sureties on the loan in the amount of $100,000 each. If Lux releases Harp without the consent of Frey or Boe, and Boe subsequently defaults, which of the following statements is correct
   a. Frey will be liable for 50% of the loan balance.
   b. Lux’s release of Harp will have no effect on Boe’s and Frey’s liability to Lux.
   c. Boe will be released for 50% of the loan balance.
   d. Frey will be liable for the entire loan balance.

**M87**

**Items 26 and 27** are based on the following information:

State Bank loaned Barr $80,000 and received securities valued at $20,000 from Barr as collateral. At the request of State, Barr entered into an agreement with Rice and Noll to act as co-sureties on the loan. The agreement provided that Rice and Noll’s maximum liability would be $80,000 each.

26. Which of the following defenses asserted by Rice will completely release Rice from liability to State?
   a. State and Barr entered into a binding agreement to extend the time for payment that increased the sureties’ risk and was agreed to without the sureties’ consent.
   b. Fraud by Barr which induced Rice to enter into the surety contract and which was unknown to State.
   c. Release of Barr’s obligation by State without Rice’s or Noll’s consent but with State’s reservation of its rights against Rice.
   d. Return of the collateral to Barr by State without Rice’s or Noll’s consent.
Selected Questions

27. If State releases Noll without Rice’s consent and Barr subsequently defaults at a time when the collateral held by State is worthless and the loan balance is $80,000, Rice’s maximum potential liability will be
   a. $0
   b. $40,000
   c. $60,000
   d. $80,000

M87#28. Adler, Field, and Hall are co-sureties with maximum liabilities of $20,000, $30,000, and $40,000, respectively. The amount of the loan with regard to which they have agreed to act as co-sureties is $90,000. The debtor defaulted at a time when the loan balance was $90,000. Adler paid the lender $18,000 in full settlement of all claims against Adler, Field, and Hall. The maximum amount that Adler may recover from Field and Hall in total is
   a. $0
   b. $12,000
   c. $14,000
   d. $70,000

M87#29. A distinction between a surety and a co-surety is that only a co-surety is entitled to
   a. Contribution.
   b. Exoneration.
   c. Subrogation.
   d. Reimbursement (Indemnification).

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#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.

N85#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>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$30,000</td>
</tr>
<tr>
<td>b. $0</td>
<td>$36,000</td>
</tr>
<tr>
<td>c. $15,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>d. $30,000</td>
<td>$30,000</td>
</tr>
</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.
M84

Items 22 and 23 are based on the following information:

Jane wishes to obtain a loan of $90,000 from Silver Corp. At the request of Silver, Jane has entered into an agreement with Bing, Piper, and Long to act as cosureties on the loan. The agreement between Jane and the cosureties stated that the maximum liability of each cosurety is: Bing $60,000, Piper $30,000, and Long $90,000. Based upon the surety relationship, Silver agreed to make the loan. After paying three installments totalling $30,000, Jane defaulted.

22. Prior to making payment, the cosureties may seek the remedy of
   a. Contribution.
   b. Indemnification.
   c. Subrogation.
   d. Exoneration.

23. If Long properly paid the entire debt outstanding of $60,000, what amount may Long recover from the cosureties?
   a. $30,000 from Bing and $20,000 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.

B. Bankruptcy

M88

Items 28 through 31 are based on the following information:

Knox operates an electronics store as a sole proprietor. On April 5, 1988, Knox was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. On April 20, a trustee in bankruptcy was appointed and an order for relief was entered. Knox’s non-exempt property has been converted to cash, which is available to satisfy the following claims and expenses as may be appropriate:

Business Law

Claims and expenses

Claim by Dart Corp. (one of Knox’s suppliers) for computers ordered on April 6, 1988 and delivered on credit to Knox on April 10, 1988. $20,000
Fee earned by the bankruptcy trustee. $15,000
Claim by Boyd for a deposit given to Knox on April 1, 1988, for a computer Boyd purchased for personal use but that had not yet been received by Boyd. $1,500
Claim by Noll Co. for the delivery of stereos to Knox on credit. The stereos were delivered on March 4, 1988, and a financing statement was properly filed on March 5, 1988. These stereos were sold by the trustee with Noll’s consent for $7,500, their fair market value. $5,000
Fees earned by the attorneys for the bankruptcy estate. $10,000
Claims by unsecured general creditors. $1,000

The cash available for distribution includes the proceeds from the sale of the stereos.

28. What amount will be distributed to the trustee as a fee if the cash available for distribution is $15,000?
   a. $ 6,000
   b. $ 9,000
   c. $10,000
   d. $15,000

29. What amount will be distributed to Boyd if the cash available for distribution is $50,800?
   a. $ 480
   b. $ 800
   c. $ 900
   d. $1,500

30. What amount will be distributed to Dart if the cash available for distribution is $41,000?
   a. $10,100
   b. $11,000
   c. $16,000
   d. $20,000

31. If the trustee in bankruptcy wishes to avoid Noll’s March 4 transaction with Knox as a preferential transfer, the trustee will
   a. Lose, because the transfer was in fact a substantially contemporaneous exchange for new value given.
   b. Lose, because there is no evidence that Knox was insolvent on March 4.
   c. Prevail, because the transfer occurred within 90 days of the filing of the bankruptcy petition.
   d. Prevail, because the financing statement was not filed on the day of delivery.
M88#32. Which of the following statements is correct with respect to a voluntary bankruptcy proceeding under the liquidation provisions of the Bankruptcy Code? a. The debtor must be insolvent. b. The liabilities of the debtor must total $5,000 or more. c. It may be properly commenced and maintained by any person who is insolvent. d. The filing of the bankruptcy petition constitutes an order for relief.

M88#33. In general, which of the following debts will be discharged under the voluntary liquidation provisions of the Bankruptcy Code? a. Debts incurred after the order for relief but before the debtor receives a discharge in bankruptcy. b. Income taxes due as the result of filing a fraudulent return seven years prior to the filing of the bankruptcy petition. c. A debt arising before the filing of the bankruptcy petition due to the debtor's negligence. d. Alimony payments owed to the debtor's spouse under a separation agreement entered into prior to the filing of the bankruptcy petition.

M88#34. On June 5, 1987, Green rented equipment under a five-year lease. On March 8, 1988, Green was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code, and a trustee was appointed. The fair market value of the equipment exceeds the balance of the lease payments due. The trustee: a. Must assume the equipment lease because its term exceeds one year. b. Must assume and subsequently assign the equipment lease. c. May elect not to assume the equipment lease. d. May not reject the equipment lease because the fair market value of the equipment exceeds the balance of the lease payments due.

M88#35. Which of the following statements is correct with respect to the reorganization provisions of the Bankruptcy Code? a. The commencement of a proceeding may be voluntary or involuntary. b. A partnership is not eligible to be a debtor. c. In all cases a trustee must be appointed. d. The debtor must be insolvent if the bankruptcy petition was filed voluntarily.

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.
   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.

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 reorga-

nization 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 their receipt of the proceeds from the disposition of the collateral.

c. Claims for unintentional torts which resulted in bodily injury to the claimant.

d. Claims arising out of the breach of a contract by the debtor.

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**

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees incurred to recover property belonging in the bankrupt's estate</td>
<td>$9,000</td>
</tr>
<tr>
<td>Costs necessary to sell the property of the estate</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

**Unsecured Claims**

<table>
<thead>
<tr>
<th>Claims</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage claims of John Doe, earned as an employee of Frank within 61 days of the filing of the bankruptcy petition</td>
<td>$3,000</td>
</tr>
<tr>
<td>Income taxes for the two years immediately preceding the filing of the bankruptcy petition</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

26. If the cash available for distribution is $12,000, what amount(s) will be distributed for expenses?

<table>
<thead>
<tr>
<th>Fees to recover property of the estate</th>
<th>Costs to sell property of the estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $6,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>c. $7,200</td>
<td>$4,800</td>
</tr>
<tr>
<td>d. $9,000</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

27. If the cash available for distribution is $25,000, what amount will be distributed for the income tax claims?

<table>
<thead>
<tr>
<th>Income tax claims</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $7,000</td>
<td></td>
</tr>
<tr>
<td>b. $8,000</td>
<td></td>
</tr>
<tr>
<td>c. $10,000</td>
<td></td>
</tr>
<tr>
<td>d. $25,000</td>
<td></td>
</tr>
</tbody>
</table>

N84#28. The trustee in bankruptcy of a landlord-debtor under a Chapter 7 liquidation

a. Must be elected by the creditors immediately after a bankruptcy petition is filed.

b. May not be appointed by the court after the order for relief has been entered.

c. Must reject the executory contracts of the debtor.

d. May assign the leases of the debtor.

M84#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.

M84#18. Under the Bankruptcy Code, one of the elements that must be established in order for the trustee in bankruptcy to void a preferential transfer to a creditor who is not an insider is that

a. The transferee-creditor received more than he would have received in a liquidation proceeding under the Bankruptcy Code.

b. Permission was received from the bankruptcy judge prior to the trustee's signing an order avoiding the transfer.

c. The transfer was in fact a contemporaneous exchange for new value given to the debtor.

d. The transferee-creditor knew or had reason to know that the debtor was insolvent.

M84#19. Bar, a creditor of Sy, has filed an involuntary petition in bankruptcy against Sy. Sy is indebted to six unsecured creditors including Bar for $6,000 each. If Sy opposes the petition, which of the following is correct?

a. Bar must be joined by at least two other creditors in filing the petition.

b. The court must appoint a trustee within ten days after the filing of the petition.

c. Bar may be required to file a bond indemnifying Sy for any losses which Sy may incur.

d. The court may not award attorneys fees to Sy due to its limited authority under the Bankruptcy Code.
V. Government Regulation of Business

A. Regulation of Employment

M88#43. Which of the following statements is correct with respect to social security taxes and benefits?
   a. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of taxable income.
   b. Benefits are available to a qualifying individual or that individual’s family only upon retirement or disability.
   c. An employer that erroneously withholds and underpays an employee’s share of social security taxes will be liable for the unpaid balance of the employee’s share.
   d. An individual whose private pension benefits exceed certain maximum limits will have social security retirement benefits reduced.

M88#44. Bing was employed as a taxi driver by Speedy, Inc. While acting in the scope and course of his employment with Speedy, Bing collided with a van driven by Hart. Hart was an independent contractor making a delivery for Troy Corp. The collision was caused solely by Bing’s negligence. As a result of the collision, both Bing and Hart suffered permanent injuries. Speedy and Troy were both in compliance with the state’s workers’ compensation statute. If Hart commences an action against Bing and Speedy for negligence, which of the following statements is correct?
   a. Hart is entitled to recover damages from Bing or Speedy.
   b. Bing will either be denied workers’ compensation benefits or have his benefits reduced because of his negligence.
   c. Hart’s action for negligence will be dismissed because Hart is an independent contractor.
   d. Hart is entitled to recover damages from Speedy’s workers’ compensation carrier to the extent no duplicate payment has been received by Hart.

M88#45. In general, which of the following statements is correct with respect to unemployment compensation?
   a. An employee who is unable to work because of a disability is entitled to unemployment compensation.
   b. An individual who has been discharged from employment because of work-connected misconduct is ineligible for unemployment compensation.
   c. The maximum period during which unemployment compensation may be collected is uniform throughout the United States.
   d. The maximum amount of weekly unemployment compensation payments made by a state is determined by federal law.

N87

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

N87#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.

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.

B-32
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.

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.

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 can not exceed the amount contributed to his account.

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.

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 only upon such individual’s disability or retirement.
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.

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.

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.
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.

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.

Jay White, an engineer, entered into a contract with Sky, Inc., agreeing to provide Sky with certain specified consulting services. After performing the services, White was paid pursuant to the contract but social security taxes were not withheld from his check since Sky considered White an independent contractor. The IRS has asserted that White was an employee and claims that a deficiency exists due to Sky's failure to withhold and pay social security taxes. Which of the following factors is most likely to support the IRS's position that White is an employee?

a. White was paid in one lump sum after all the services were performed.

b. White provided his own office and supplies.

c. Sky supervised and controlled the manner in which White performed the services.

d. Sky reserved the right to inspect White's work.

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.

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.

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.

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.
Selected Questions

M84#40. Social security benefits are available
a. To a qualifying individual or his family only
b. Only to those who have taxable income under
    a maximum limitation.
c. To an otherwise qualifying individual who is
    also receiving payments under a private pension plan.
d. To children of a deceased worker who was
    covered under social security, until such children
    reach age 25 or complete their education, whichever occurs first.

M84#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.

M84#36. The principal purpose of the registration requirements of the Securities Act of 1933 is to
a. Prevent public offerings of securities in which management fraud or unethical conduct is suspected.
b. Provide the SEC with the information necessary to determine the accuracy of the facts presented in the financial statements.
c. Assure that investors have adequate information upon which to base investment decisions.
d. Provide the SEC with the information necessary to evaluate the financial merits of the securities being offered.

M88#38. Which of the following statements is correct with respect to the Securities Exchange Act of 1934?

a. Issuers whose securities are registered under the Act are required to comply with its reporting requirements.
b. The Act applies only to issuers whose securities are traded on a national securities exchange.
c. The Act subjects all issuers of securities to its registration requirements if the issuer has more than $2.5 million of assets or more than 250 shareholders.
d. The antifraud provisions of the Act do not apply to issuers of securities that are exempt from the Act's registration requirements.

M88#39. In order to raise $375,000, Penn Corp. is offering its securities under Rule 504 of Regulation D of the Securities Act of 1933. Under Rule 504, the offering

a. Must be sold to accredited investors.
b. Can not be sold to more than 35 non-accredited investors.
c. Can be sold to an unlimited number of accredited and non-accredited investors.
d. Will not subject the issuer to the antifraud provisions of the Securities Act of 1933.

M88#40. If securities are registered under the Securities Exchange Act of 1934, which of the following disclosure provisions apply?

<table>
<thead>
<tr>
<th>Notice of sales of the registered securities by the corporation's officers must be filed with the SEC</th>
<th>Proxy material for the registered securities must be filed with the SEC</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</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>No</td>
</tr>
</tbody>
</table>

M88#41. Which of the following are exempt from the registration requirements of the Securities Act of 1933?

a. All industrial development bonds issued by municipalities.
b. Stock of a corporation offered and sold only to residents of the state in which the issuer was incorporated and doing all of its business.
c. Bankers' acceptances with maturities at the time of issue ranging from one to two years.
d. Participation interests in a money market fund that consists wholly of short-term commercial paper.
M87#42. In general, the Securities Act of 1933 provides for an exemption from registration for

<table>
<thead>
<tr>
<th>A stock dividend issued to existing shareholders</th>
<th>Bonds issued by a municipality for governmental purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.  Yes</td>
<td>a.  No</td>
</tr>
<tr>
<td>b.  Yes</td>
<td>b.  Yes</td>
</tr>
<tr>
<td>c.  No</td>
<td>c.  Yes</td>
</tr>
<tr>
<td>d.  No</td>
<td>d.  No</td>
</tr>
</tbody>
</table>

M87#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.

M87#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.

M87#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.

M87#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 by-laws.
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.

M87#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.

M87#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.

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 regis-
tered 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 not 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.

N86#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.

N86#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.

N86#32. 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.
N86#33. 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.

N86#34. 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.

N86#35. 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.

N86#36. 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.

M86#19. 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.

M86#20. 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.

M86#21. 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.

M86#22. 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.

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.
Selected Questions

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.

M84#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.

M84#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.

M84#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.

M84#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.

M84#34. The anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934
   a. Are the same insofar as the transactions to which they apply.
   b. Are unavailable to plaintiffs who are unable to establish diversity of citizenship and a minimum of $10,000 monetary damages.
   c. Contain criminal sanctions against those who engage in fraudulent activities.
   d. Contain remedies which are mutually exclusive of each other.
**Business Law**

**VI. Uniform Commercial Code**

A. Commercial Paper

**M86#46.** Ard is holding the following instrument:

I, Rosemary Larkin, hereby promise to pay to the bearer twenty thousand dollars ($20,000). This document is given by me as payment of the balance due on my purchase of a 1984 Winnebago mobile home from Ed Dill and is payable when I am able to obtain a bank loan.

[Signature]

Rosemary Larkin

This instrument is not negotiable because it
a. Refers to the contract out of which it arose.
b. Is payable to bearer rather than to a named payee.
c. Is not dated on the face of the instrument.
d. Is not payable at a definite time.

**M86#47.** Assuming each of the following is negotiable, which qualifies as a draft under the UCC Commercial Paper Article?

a. A warehouse receipt.
b. A demand promissory note.
d. A trade acceptance.

**M86#48.** The value requirement in determining whether a person is a holder in due course with respect to a check will not be satisfied by the taking of the check
a. As security for an obligation to the extent of the obligation.
b. As payment for an antecedent debt.
c. In exchange for another negotiable instrument.
d. In exchange for a promise to perform services in the future.

**N87#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.

**N87#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]

Mary Kurke

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.

**N87#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.

**N87#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

_________ Cash

Five hundred Dollars

at Miami, Florida

[Signature]

Craig Burke

Value received with interest at the rate of nine percent per annum.

This instrument is secured by a conditional sales contract.

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.
Selected Questions

N87#49. One of the requirements necessary to qualify as a holder of a negotiable bearer check is that the transference 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.

N87#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.

N87#46. Which of the following on the face of an otherwise negotiable instrument will affect the instrument'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 value 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 promissory 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#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. Forger of the maker's signature.
   d. Discharge of the maker in bankruptcy.

N86#43. Which of the following prevents an instrument from being negotiable?
   a. An endorsement on the back of the instrument which reads: "Pay Smith only."
   b. An instrument which is payable after completion 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 instrument is intended to be a note or a draft.
   d. The capacity in which the party signed was unclear.

N86#44. Your client has in its possession the following instrument:

<table>
<thead>
<tr>
<th>FAIR FOOD WHOLESALERS, INC.</th>
</tr>
</thead>
<tbody>
<tr>
<td>22 Woodrow Wilson Hayes Lane</td>
</tr>
<tr>
<td>Columbus, Ohio</td>
</tr>
<tr>
<td>Jan. 10, 1986</td>
</tr>
</tbody>
</table>

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.
Business Law

M86#26. An instrument reads as follows:

<table>
<thead>
<tr>
<th>Pay</th>
<th>April 1, 1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>to the</td>
<td></td>
</tr>
<tr>
<td>Order of Donald Kent,</td>
<td></td>
</tr>
<tr>
<td>Fifteen days after</td>
<td>$100.00</td>
</tr>
<tr>
<td>date</td>
<td></td>
</tr>
<tr>
<td>One hundred and no/100</td>
<td>Dollars</td>
</tr>
<tr>
<td>Union Corp.</td>
<td></td>
</tr>
<tr>
<td>Ridgefield, Connecticut</td>
<td></td>
</tr>
<tr>
<td>re: down payment on auto</td>
<td></td>
</tr>
<tr>
<td>purchase</td>
<td></td>
</tr>
</tbody>
</table>

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#29. 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.       
J.C. Kahn, President         

ACCEPTED: Clark Novelties, Inc.  
BY: 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 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#29. The UCC Article on Commercial Paper requires that an instrument, to be negotiable, must “con-
tain 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.

M86#31. 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 presentation 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.

M85#36. An instrument complies with the requirements for negotiability contained in the UCC Article on Commercial Paper. The instrument contains language expressly acknowledging the receipt of $40,000 by Mint Bank and an agreement to repay principal with interest at 11% six months from date. The instrument is
a. A banker’s acceptance.
b. A banker’s draft.
c. A negotiable certificate of deposit.
d. Nonnegotiable because of the additional language.

M85#37. Jane Lane, a sole proprietor, has in her possession several checks which she received from her customers. Lane is concerned about the safety of the checks since she believes that many of them are bearer paper which may be cashed without endorsement. The checks in Lane’s possession will be considered order paper rather than bearer paper if they were made payable (in the drawer’s handwriting) to the order of
a. Cash.
b. Ted Tint, and endorsed by Ted Tint in blank.
c. Bearer, and endorsed by Ken Kent making them payable to Jane Lane.
d. Bearer, and endorsed by Sam Sole in blank.
**Selected Questions**

**N85#38.** The requirements for an instrument to qualify as negotiable commercial paper
   a. May be waived by a separate agreement signed by the original parties to the instru-
      ment 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 instru-
      ment is negotiable.
   d. Must be satisfied at least in principle, although the exact language set forth in the
      UCC may be varied.

**N85#39.** John Daly received a check which was originally made payable to the order of one of his cus-
          tomers, 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.

**N85#40.** Below is a note which your client Best Realtors obtained from Green in connection with Green’s
          purchase of land located in Rye, N.Y. The note was given for the balance due on the purchase and was
          secured by a first mortgage on the land.

$90,000.00
Rye, N.Y.
May 1, 1985

For value received, six years after date, I promise to pay to the order of Best Realtors NINETY
THOUSAND and 00/100 DOLLARS with interest at 16% compounded annually until fully paid. This
instrument arises out of the sale of land located in N.Y. and the law of N.Y. is to be applied to any
question which may arise. It is secured by a first mortgage on the land conveyed. It is further agreed
that:
1. Purchaser will pay the costs of collection including attorney’s fees upon default.
2. Purchaser may repay the amount outstanding on any anniversary date of this note.

Ted Green

This note is a
   a. Negotiable promissory note.
   b. Negotiable investment security under the UCC.
   c. Nonnegotiable promissory note since it is secured by a first mortgage.
   d. Nonnegotiable promissory note since it permits prepayment and requires the maker’s
      payment of the costs of collection and attorney’s fees.

**N85#41.** Hunt has in his possession a negotiable instrument which was originally payable to the order of
          Carr. It was transferred to Hunt by a mere delivery by Drake, who took it from Carr in good faith in satisfac-
          tion of an antecedent debt. The back of the instrument read as follows, “Pay to the order of Drake in satisfac-
          tion 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.

**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 (an)
   a. Assignee since a payee may 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.
**M85#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.

**M85#35.** A holder in due course will take free of which of the following defenses?

a. A wrongful filling-in of the amount payable which was omitted from the instrument.
b. Duress of a nature which renders the obligation of the party a nullity.
c. Infancy to the extent that it is a defense to a simple contract.
d. Discharge of the maker in bankruptcy.

**M85#36.** Your client, MDS Discount Services, Inc., purchased the following instrument from John Cross on February 15, 1985. Cross had received it in connection with the sale to Dann Corp. of real property he owned located in Utah. Cross endorsed it in blank and received $24,000 from MDS.

```
$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.

[Signature]

President

---

The instrument is

a. Non-negotiable due to the language contained in clause number 1.
b. Non-negotiable since it incorporates by reference the terms of the mortgage indicated in clause number 2.
c. Negotiable since it contains the words “value received” and specifies the required recitation of the transaction out of which it arose.
d. Negotiable despite the language contained in clauses numbered 1, 2, and 3.

---

**M85#33.** The following instrument was received by Kerr:

```
Madison, Wisconsin April 5, 1985

Sixty days after date pay to the order of Donald Kerr, one hundred and fifty dollars ($150). Value received and charge the trade account of Olympia Sales Corp., N.Y.

[Signature]

by Carl Starr

President

Olympia Sales Corp.

To: New City Bank,
U.N. Plaza,
New York, N.Y.
```

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.
Selected Questions

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.

N84#46. Which of the following is covered under the UCC Article on commercial paper?
   a. An investment security.
   c. A promissory note payable 10 days after presentment.
   d. A negotiable warehouse receipt.

N84#47. Sinka Corp. has the following instrument in its possession:

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 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.
Items 36 to 38 and 40 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.
(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.
Selected Questions

B. Documents of Title and Investment Securities

M86#49. The procedure necessary to negotiate a document of title depends principally on whether the document is

- An order document or a bearer document.
- Issued by a bailee or a consignee.
- A receipt for goods stored or goods already shipped.
- A bill of lading or a warehouse receipt.

M87#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

- Liable because it was negligent.
- Liable because it is strictly liable for any loss.
- Not liable unless Grey can establish that Bond was grossly negligent.
- Not liable because the warehouse receipt was negotiable.

M87#47. Assuming all other requirements have been met, which of the following terms generally must be included in a writing in order to satisfy the UCC statute of frauds regarding the sale of securities?

<table>
<thead>
<tr>
<th>Price</th>
<th>Quantity</th>
<th>Time of payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M86#48. Klep burglarized the premises of Apple Sales Co. He stole several negotiable warehouse receipts which were deliverable to the order of Apple. Klep indorsed Apple’s name on the instruments and transferred them to Margo Wholesalers, a bona fide purchaser for value. As between Apple and Margo,

- Apple will prevail since the warehouseman must be notified before any negotiation is effective.
- Apple will prevail since the thief’s indorsement prevents a due negotiation.
- Margo will prevail since it has taken a negotiable warehouse receipt as a bona fide purchaser for value.
- Margo will prevail since the warehouse receipt was converted to a bearer instrument by Klep’s indorsement.

M86#32. Under the UCC a warehouse receipt
a. May be issued only by a bonded and licensed warehouseman.
b. Will not be negotiable if it contains a contractual limitation on the warehouseman’s liability.
c. Is negotiable if by its terms the goods are to be delivered to bearer or the order of a named person.
d. May qualify as both a negotiable warehouse receipt and negotiable commercial paper if the instrument is payable, alternatively, in money or by the delivery of goods.

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?

- June 11 — Spark signed a contract to buy the engines from Bell for $19,000. Delivery was to be at the warehouse.
- June 12 — Spark paid for the engines.
- June 13 — Bell negotiated the warehouse receipt to Spark.
- 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.
C. Sales

M88#50. Under the UCC Sales Article, which of the following warranties requires the seller to be a merchant with respect to the goods being sold in order for the warranty to apply?

<table>
<thead>
<tr>
<th>Implied warranty of fitness for a particular purpose</th>
<th>Implied warranty of merchantability</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>

N87#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.

N87#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.

N87#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.

N87#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.

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.
Selected Questions

M87. Items 52 and 53 are based on the following information:

On April 5, 1987, Anker, Inc., furnished Bold Corp. with Anker’s financial statements dated March 31, 1987. The financial statements contained misrepresentations which indicated that Anker was solvent when in fact it was insolvent. Based on Anker’s financial statements, Bold agreed to sell Anker 90 computers, “F.O.B. — Bold’s loading dock.” On April 14, Anker received 60 of the computers. The remaining 30 computers are in the possession of the common carrier and in transit to Anker.

52. If on April 28, Bold discovered that Anker was insolvent, then with respect to the computers delivered to Anker on April 14, Bold may:
   a. Reclaim the computers upon making a demand.
   b. Reclaim the computers irrespective of the rights of any subsequent third party.
   c. Not reclaim the computers since ten days have elapsed from its delivery.
   d. Not reclaim the computers since it is entitled to recover the price of the computers.

53. With respect to the remaining 30 computers in transit, which of the following statements is correct if Anker refuses to pay Bold in cash and Anker is not in possession of a negotiable document of title covering the computers?
   a. Bold may stop delivery of the computers to Anker since their contract is void due to Anker’s furnishing of the false financial statements.
   b. Bold may stop delivery of the computers to Anker despite the fact that title had passed to Anker.
   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.

N86#45. 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.

N86#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.

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.

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, then:
   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.

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 was involved.
   d. The manufacturer will avoid liability if it can show it followed the custom of the industry.

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.
**Business Law**

**M86#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.

**M85#42.** The Uniform Commercial Code's position on privity of warranty as to personal injuries
   a. Allows the buyer's family the right to sue only the party from whom the buyer purchased the product.
   b. Resulted in a single uniform rule being adopted throughout most of the United States.
   c. Prohibits the exclusion on privity grounds of third parties from the warranty protection it has granted.
   d. Applies exclusively to manufacturers.

**M85#43.** Flax telephoned Sky Corp. and ordered a specially manufactured air conditioner for $1,900. Subsequently, Flax realized that he miscalculated the area which was to be cooled and concluded that the air conditioner would not be acceptable. Sky had already completed work on the air conditioner, demanded payment, and was unable to resell the unit at a reasonable price. If Flax refuses to pay and Sky brings an action seeking as damages the price plus reasonable storage charges of $50, Sky will recover
   a. Nothing, because of the statute of frauds.
   b. Only its lost profit.
   c. The full $1,950.
   d. Only $1,900.

**N84#53.** Bizzy Corp. wrote Wang ordering 100 Wang radios for $2500. Wang 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.

**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 perfu-
torily examined and sent to a nearby warehouse for storage until needed. On the following day, upon closer examination, it was discovered that the quality of the linings of the suits was inferior to that specified in the sales contract. Which of the following is correct insofar as Tara’s rights are concerned?
   a. Tara must retain the suits since it accepted them and had an opportunity to inspect them upon delivery.
   b. Tara had no rights if the linings were of merchantable quality.
   c. Tara can reject the suits upon subsequent discovery of the defects.
   d. Tara’s only course of action is rescission.

M84#47. Reed purchased 50 dozen pen sets from Wok Corp. Reed made substantial prepayments of the purchase price. Wok is insolvent and the goods have not been delivered as promised. Reed wants the pens. Under the circumstances, which of the following will prevent Reed from obtaining the pens?
   a. The fact that the goods have not been identified to his contract.
   b. The fact that he was not aware of Wok’s insolvency at the time he purchased the pens.
   c. The fact that he can obtain a judgment for damages.
   d. The fact that he did not pay the full price at the time of the purchase even though he has made a tender of the balance and holds it available to Wok upon delivery.

M84#48. Nat purchased a typewriter from Rob. Rob is not in the business of selling typewriters. Rob tendered delivery of the typewriter after receiving payment in full from Nat. Nat informed Rob that he was unable to take possession of the typewriter at that time, but would return later that day. Before Nat returned, the typewriter was destroyed by a fire. The risk of loss
   a. Passed to Nat upon Rob’s tender of delivery.
   b. Remained with Rob, since Nat had not yet received the typewriter.
   c. Passed to Nat at the time the contract was formed and payment was made.
   d. Remained with Rob, since title had not yet passed to Nat.

M84#49. Bell by telegram to Major Corp. ordered 10,000 yards of fabric, first quality, 50% wool and 50% cotton. The shipping terms were f.o.b. Bell’s factory in Akron, Ohio. Major accepted the order and packed the fabric for shipment. In the process it discovered that one half of the fabric packed had been commingled with fabric which was 30% wool and 70% cotton. Since Major did not have any additional 50% wool fabric, it decided to send the shipment to Bell as an accommodation. The goods were shipped and later the same day Major wired Bell its apology informing Bell of the facts and indicating that the 5,000 yards of 30% wool would be priced at $2 a yard less. The carrier delivering the goods was destroyed on the way to Akron. Under the circumstances, who bears the risk of loss?
   a. Bell, since Bell has title to the goods.
   b. Major, because the order was not a signed writing.
   c. Bell, since the shipping terms were f.o.b. Bell’s place of business.
   d. Major, since they shipped goods which failed to conform to the contract.

M84#50. Which of the following statements is correct with regard to an auction of goods?
   a. The auctioneer may withdraw the goods at any time prior to completion of the sale unless the goods are put up without reserve.
   b. A bidder may retraction 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.

M84#51. Sand Corp. received an order for $11,000 of assorted pottery from Gluco, Inc. The shipping terms were f.o.b. Lime Ship Lines, seller’s place of business, 2/10, net/30. Sand packed and crated the pottery for shipment and it was loaded upon Lime’s ship. While the goods were in transit to Gluco, Sand learned that Gluco was insolvent in the equity sense (unable to pay its debts in the ordinary course of business). Sand promptly wired Lime’s office in Galveston, Texas, and instructed them to stop shipment of the goods to Gluco and to store them until further instructions. Lime complied with these instructions. Regarding the rights, duties, and liabilities of the parties, which of the following is correct?
   a. Gluco is entitled to the pottery if it pays cash.
   b. Sand’s stoppage in transit was improper if Gluco’s assets exceeded its liabilities.
   c. The fact that Gluco became insolvent in no way affects the rights, duties, and obligations of the parties.
   d. Once Sand correctly learned of Gluco’s insolvency, it had no further duty or obligation to Gluco.

M84#52. Under the UCC, the warranty of title for the sale of goods
   a. May not be excluded by the seller.
   b. May be excluded by the phrase “as is.”
   c. Will vest title absolutely in a bona fide purchaser for value provided that the seller is a merchant.
   d. Will apply regardless of whether it is provided in the contract unless it is specifically excluded.
M84#53. Olsen purchased a used van from Super Sales Co. for $350. A clause in the written contract in boldface type provided that the van was being sold "as is." Another clause provided that the contract was intended as the final expression of the parties' agreement. After driving the van for one week, Olsen realized that the engine was burning oil. Olsen telephoned Super and requested a refund. Super refused but orally gave Olsen a warranty on the engine for six months. Three weeks later the engine exploded. Super's oral warranty
a. Is invalid since the modification of the existing contract required additional consideration.
b. Is invalid due to the Statute of Frauds.
c. Is valid and enforceable.
d. Although valid, proof of its existence will be inadmissible because it contradicts the final written agreement of the parties.

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.

D. Secured Transactions

N87#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.

N87#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.

N87#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.

N87#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.

M87#56. On March 1, Dun purchased $30,000 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.
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>
</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>No</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

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.
M84#40. Myles Software, Inc., a wholesale distributor of software computer products, borrowed $100,000 from the Gem Finance Co. secured by Myles’ present and future inventory and accounts receivable and the proceeds thereof. The parties signed a financing statement which described the collateral and was filed in the appropriate state office. Myles subsequently defaulted in the repayment of the loan and Gem attempted to enforce its security interest. Myles contended that Gem’s security interest was unenforceable. In addition, Johns, who subsequently gave credit to Myles without knowledge of Gem’s security interest, is also attempting to defeat Gem’s alleged security interest. The security interest in question is

a. Valid in respect to Myles but not as to Johns.

b. Invalid in respect to both Myles and Johns.

c. Invalid in respect to Myles but not as to Johns.

d. Valid in respect to both Myles and Johns.

M85#40. A typewriter, which was subject to a prior UCC security interest, was delivered to Ed Fogel for repair. Fogel is engaged in the business of repairing typewriters. Fogel repaired the typewriter. However, the owner of the typewriter now refuses to pay for the services performed by Fogel. The state in which Fogel operates his business has a statute which gives Fogel a mechanics lien on the typewriter. Fogel’s mechanics lien

a. Takes priority over a prior perfected security interest under all circumstances.

b. Is subject to a prior perfected purchase money security interest under all circumstances.

c. Is subject to a prior unperfected security interest where the statute is silent as to priority.

d. Takes priority over a prior perfected security interest unless the statute expressly provides otherwise.

M85#45. Under the UCC, collateral which has been sold in a private sale by a secured party to a good faith purchaser for value after the debtor’s default

a. May be redeemed by the debtor within 10 days after the disposition.

b. May be redeemed by creditors with subordinate claims.

c. Remains subject to the security interests of subordinate lien creditors in all cases where the collateral is disposed of at a private sale.

d. Discharges the security interest pursuant to which such sale was made and any security interest or lien subordinate thereto.

M85

Items 44 and 45 are based on the following information:

On June 3, Muni Finance loaned Page Corp. $20,000 to purchase four computers for use in Page’s trucking business. Page contemporaneously executed a promissory note and security agreement. On June 7, Page purchased the computers with the $20,000, obtaining possession that same day. On June 10, Mort, a judgment creditor of Page, levied on the computers.

44. Which of the following statements is correct?

a. Muni failed to qualify as a purchase money secured lender.

b. Muni’s security interest attached on June 3.

c. Muni’s security interest attached on June 7.

d. Muni’s security interest did not attach.

45. If Muni files a financing statement on June 11, which of the parties will have a priority security interest in the computers?

a. Mort, since he lacked notice of Muni’s security interest.

b. Mort, since Muni failed to file before Mort levied on the computers.

c. Muni, since its security interest was perfected within the permissible time limits.

d. Muni, since its security interest was automatically perfected upon attachment.

M85#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.

M85

Items 47 and 48 are based on the following information:

Foxx purchased a stereo for personal use from Dix Audio, a retail seller of appliances. Foxx paid 30% of the $600 sales price and agreed to pay the balance in 12 equal principal payments plus interest. Foxx executed a security agreement giving Dix a security interest in the stereo. Dix properly filed a financing statement immediately. After making six payments Foxx defaulted.

47. If Dix takes possession of the stereo, it

a. Must dispose of the stereo at a public sale.

b. Must dispose of the stereo within 90 days after taking possession or be liable to the debtor.

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 not have to file a financing statement to perfect its security interest against competing creditors in the equipment sold by Minor?
   a. Sales made to retailers who in turn sell to buyers in the ordinary course of business.
b. Sales made to any buyer when the equipment becomes a fixture.
c. Sales made to health clubs.
d. Sales made to consumers who purchase for their own personal use.

N84#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.

N84#58. Milo Manufacturing Corp. sells baseball equipment to distributors, who in turn sell the equipment to various retailers throughout the U.S. The retailers then sell the equipment to consumers who use the equipment for their own personal use. In all cases, the equipment is sold on credit with a security interest taken in the equipment by each of the respective sellers. Which of the following is correct?
   a. The security interests of all of the sellers remain valid and will take priority even against good faith purchasers for value, despite the fact that resales were contemplated.
b. The baseball equipment is inventory in the hands of all the parties concerned.
c. Milo’s security interest is automatically perfected since Milo qualifies as a purchase money secured party.
d. Milo and the distributors must file a financing statement or take possession of the baseball equipment in order to perfect their security interests.

N84#59. Sax purchased from Bosch Tools a new saw for his home workshop for cash. One week later, Sax was called by Cary Finance. Cary explained to Sax that it had been financing Bosch’s purchases from the 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.

N84#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.

B-55
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.

VII. Property

A. Real and Personal Property

M88#51. A purchaser of real property who wishes to receive the broadest protection with respect to the property being conveyed should obtain a

a. Bargain and sale deed.

b. General warranty deed.

c. Quitclaim deed.

d. Grant deed.

M88 Items 53 and 54 are based on the following information:

Boch and Kent are equal owners of a warehouse. Boch died leaving a will that gave his wife all of his right, title, and interest in his real estate.

53. If Boch and Kent owned the warehouse at all times as joint tenants with the right of survivorship, Boch's interest

a. Will pass to his wife after the will is probated.

b. Will not be included in his gross estate for federal estate tax purposes.

c. Could not be transferred before Boch's death without Kent's consent.

d. Passed to Kent upon Boch's death.

54. If Boch and Kent owned the warehouse at all times as tenants in common, which of the following statements is correct?

a. Boch's interest will pass to his wife after the will is probated.

b. Upon Boch's death, all tenancies in common terminated.

c. Boch's interest will not be included in his gross estate for federal estate tax purposes.

d. Upon Boch's death, his interest passed to Kent.

M88#55. Sisk is a tenant of Met Co. and has two years remaining on a six-year lease executed by Sisk and Met. The lease prohibits subletting but is silent as to Sisk's right to assign the lease. Sisk assigned the lease to Kern Corp. which assumed all of Sisk's obligations under the lease. Met objects to the assignment. Which of the following statements is correct?

a. The assignment to Kern is voidable at Met's option.

b. Sisk would have been relieved from liability on the lease with Met if Sisk obtained Met's consent to the assignment.

c. Sisk will remain liable to Met for the rent provided for in the lease.

d. With respect to the rent provided for in the lease, Kern is liable to Sisk but not to Met.
Selected Questions

N87#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.

N87

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 1/3 interest in the building as a joint tenant.
b. A 1/2 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 1/2 interest in the building as a tenant in common.
c. Care and Lark each own a 1/2 interest in the building as joint tenants.
d. Knox's heirs and Lark each own a 1/3 interest in the building as tenants in common.

N87#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.

N87#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.

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 1/3 interest in the land.
c. C and D will each own a 1/4 interest in the land.
d. The tenancy in common will terminate.

57. If C sells her interest in the land to X, which of the following is true?

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.

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.

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 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.

M86
Items 43 and 44 are based on the following information:

Abel, Boyd, and Cox are relatives who own a parcel of undeveloped land as joint tenants with right of survivorship. Abel sold his interest in the land to Zahn.

43. As a result of the sale from Abel to Zahn,
   a. Zahn will acquire a ½ interest in the land as a joint tenant.
   b. Zahn will acquire a ½ interest in the land as a tenant in common.
   c. Boyd and Cox will each own a ½ interest in the land as tenants in common.
   d. Boyd and Cox must consent before Zahn will acquire any interest in the land.

44. If both Boyd and Zahn die, which of the following is correct with respect to the ownership of the land?
   a. Cox and Zahn’s heirs are tenants in common with ownership interests as follows: Cox ⅔ and Zahn’s heirs ⅓.
   b. Cox and Zahn’s heirs are joint tenants with ownership interests as follows: Cox ⅔ and Zahn’s heirs ⅓.
   c. Cox, Boyd’s heirs, and Zahn’s heirs each own a ⅓ interest as tenants in common.
   d. Cox owns the entire interest.

M86#45. Frey Products, Inc., leased ten lathes from Tri Corp., a manufacturer of lathes. The lease provided for monthly payments of $2,000 per month for 60 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.

M86#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 ½ interest in certain real property as tenants in common. Jane’s interest is
   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.
**Selected Questions**

**M85**

**Items 52 and 53 are based on the following information:**

On July 1, Bean deeded her home to Park. The deed was never recorded. On July 5, Bean deeded the same home to Noll. On July 9, Noll executed a deed, conveying his title to the same home to Baxter. On July 10, Noll and Baxter duly recorded their respective deeds.

52. In order for Noll's deed from Bean to be effective it must
   a. Contain the actual purchase price paid by Noll.
   b. Be signed by Noll.
   c. Include a satisfactory description of the property.
   d. Be recorded with Bean's seal affixed to the deed.

53. If Noll and Baxter are bona fide purchasers for value, which of the following statements is correct?
   a. Baxter's interest is superior to Park's.
   b. Bean's deed to Park was void as between Bean and Park because it was not recorded.
   c. Bean's deed to Noll was void because she had no interest to convey.
   d. Baxter can recover the purchase price from Noll.

**M85#54.** In order to create an easement by prescription a person must, in addition to fulfilling other requirements, have
   a. Recorded the easement immediately upon its creation.
   b. Received the express or implied consent of the true owner.
   c. Used the land of another out of necessity.
   d. Used the land of another in a manner that is open and notorious.

**B. Mortgages**

**M88#52.** In general, which of the following statements is correct with respect to a real estate mortgage?
   a. The mortgage must be in writing and signed by both the mortgagor (borrower) and mortgagee (lender).
   b. The mortgagee may assign the mortgage to a third party without the mortgagor's consent.
   c. The mortgage need not contain a description of the real estate covered by the mortgage.
   d. The mortgage must contain the actual amount of the underlying debt and the rate of interest.

**M88#56.** Bell obtained a $30,000 loan from Arco Bank, executing a promissory note and mortgage. The loan was secured by a building that Bell purchased from Marx for $50,000. Arco's recording of the mortgage
   a. Generally does not affect the rights of Bell and Arco against each other under the promissory note.
   b. Generally creates a possessory security interest in Arco.
   c. Cuts off the rights of all prior and subsequent lessees of the building.
   d. Transfers legal title to the building to Arco.

**M88#57.** On April 6, 1988, Walsh purchased a warehouse from Bock for $150,000. Best Title Co. had performed a title search of the property. The results of the title search indicated that a mortgage given to Stone by Bock was duly recorded against the warehouse on March 9, 1988. However, the title search failed to detect a purchase money mortgage dated March 2, 1988, given by Bock to Todd. This mortgage was never recorded. Walsh was unaware of the mortgage to Todd. Under the circumstances,
   a. Walsh will take title to the warehouse subject to Todd's mortgage because it is a purchase money mortgage.
   b. Walsh will take title to the warehouse free of Todd's mortgage.
   c. Todd's mortgage is superior to Stone's mortgage.
   d. Best will liable to Walsh because of its failure to detect the Todd mortgage.

**M88#58.** Shea Corp. owns a factory that has a fair market value of $50,000. Deal Bank holds a first mortgage and Rift Finance holds a second mortgage on the factory. Shea has discontinued payments to Deal and Rift. As a result, Deal, which is owed $45,000, and Rift, which is owed $15,000, have foreclosed on their respective mortgages. If the factory is properly sold to Bean at a judicial sale for $50,000, after expenses,
   a. Deal will receive $37,500 out of the proceeds.
   b. Rift will receive $5,000 out of the proceeds.
   c. Rift has a right of redemption after the judicial sale.
   d. Bean will take the factory subject to the unsatisfied portion of any mortgage.

**N87#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.

**N87#52.** Lusk borrowed $20,000 from Marco Finance. The loan was secured by a mortgage on a fourunit 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.

M86#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.

M86#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.

M86#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 mortgagee 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-type 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.

M86#50. Wax Corp. owns a warehouse which has a fair market value of $70,000. Arco Bank is holding a first mortgage and Stark Finance a second mortgage on the warehouse. Wax has discontinued payments to Arco and Stark. As a result, Arco, which has an outstanding mortgage of $60,000, and Stark, which has an outstanding mortgage of $15,000, have foreclosed on
their respective mortgages. If the warehouse is properly sold to Dean at a judicial sale for $70,000, after expenses,

- Dean will take the warehouse subject to the unsatisfied portion of any mortgage.
- Stark will receive $10,000 out of the proceeds.
- Arco will receive $56,000 out of the proceeds.
- Stark has a right of redemption after the judicial sale.

M85

**Items 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 mortgagee, 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?

- Byrd is liable to Fale for any deficiency.
- Byrd is secondarily liable to Fale as a surety.
- Slade was automatically released from all liability to Fale upon Byrd’s acquisition of the building subject to the mortgage.
- Slade is liable to Fale for any resulting deficiency.

56. As a result of the foreclosure sale

- Fale is entitled to receive the full $280,000 out of the proceeds.
- Fale is entitled to receive $240,000 out of the proceeds.
- Foxx is entitled to receive its full $50,000 from either Byrd or Slade.
- Foxx is entitled to receive $50,000 out of the proceeds.

M85#55. Lake purchased a home from Walsh for $95,000. Lake obtained a $60,000 loan from Safe Bank to finance the purchase, executing a promissory note and mortgage. The recording of the mortgage by Safe

- Gives the world actual notice of Safe’s interest.
- Protects Safe’s interest against the claims of subsequent bona fide purchasers for value.
- Is necessary in order that Safe have rights against Lake under the promissory note.
- Is necessary in order to protect Safe’s interest against the claim of a subsequent transferee who does **not** give value.

M85#56. Gray owned a warehouse free and clear of any encumbrances. Gray borrowed $30,000 from Harp Finance and executed a promissory note secured by a mortgage on the warehouse. The state within which the warehouse was located had a notice-race recording statute applicable to real property. Harp did not record its mortgage. Thereafter, Gray applied for a loan with King Bank, supplying King with certified financial statements which disclosed Harp’s mortgage. After review of the financial statements, King approved Gray’s loan for $25,000, taking an executed promissory note secured by a mortgage on the warehouse. King promptly recorded its mortgage. Which party’s mortgage will be superior?

- Harp’s, since King had notice of Harp’s interest.
- Harp’s, since it obtained a purchase money security interest.
- King’s, since it was the first to file.
- King’s, since a title search would fail to reveal Harp’s interest.

M85#57. A mortgagor who defaults on his mortgage payments will not be successful if he attempts to

- Assert the equitable right to redeem.
- Redeem the property after a judicial foreclosure sale has taken place.
- Obtain any excess resulting from a judicial foreclosure sale.
- 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.

C. **Fire and Casualty Insurance**

M88#59. On April 2, 1987, Ritz Corp. purchased a warehouse that it insured for $500,000. The policy contained a 75% coinsurance clause. On April 25, 1988, a fire caused $900,000 damage to the warehouse. The fair market value of the warehouse was $800,000 on April 2, 1987, and $1 million on April 25, 1988. Ritz is entitled to receive insurance proceeds of, at most,

- $375,000.
- $500,000.
- $600,000.
- $750,000.

M88#60. Beal occupies an office building as a tenant under a 25-year lease. Beal also has a mortgagee’s (lender’s) interest in an office building owned by Hill Corp. In which capacity does Beal have an insurable interest?

<table>
<thead>
<tr>
<th>Tenant</th>
<th>Mortgagee</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>
N87#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.

N87#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.

N87#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.

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 insurer 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.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons
   - N86# 3 d
   - N87# 31 d
   - C. Workpapers, Confidentiality
   - N86# 3 c
   - N87# 5 c
   - N85# 5 c
   - M88# 3 d
   - N86# 6 b
   - N87# 10 b
   - B. Federal Statutory Liability
   - N84# 5 b
   - N84# 8 b
   - M88# 1 b
   - N86# 2 b
   - N87# 30 b
   - N86# 1 c
   - N86# 2 b

B. Agency
   - M84# 3 a
   - M84# 4 b
   - M85# 7 b
   - M85# 15 d
   - M84# 5 d
   - M84# 6 b
   - N87# 23 b
   - N87# 24 b
   - M88# 7 a
   - N84# 11 c
   - M84# 7 d
   - M84# 8 c
   - M84# 9 d
   - M84# 10 d
   - M87# 4 d
   - M88# 14 d

B. Partnerships and Joint Ventures
   - M88# 1 b
   - N86# 59 a
   - N86# 60 d
   - M85# 1 d
   - N85# 2 b
   - M85# 3 a
   - N85# 5 c
   - N84# 14 a
   - N84# 15 d
   - N84# 1 a
   - M84# 2 a

C. Corporations
   - M88# 15 c
   - N87# 1 d
   - M85# 3 d
   - N85# 3 c
   - N85# 4 d
   - M85# 5 a
   - M85# 11 b
   - M85# 54 a
   - M85# 58 b

II. Business Organizations

A. Agency
   - M84# 3 a
   - M84# 4 b
   - M85# 7 b
   - M85# 15 d
   - M84# 5 d
   - M84# 6 b
   - M88# 4 a
   - M88# 5 d
   - M88# 6 b
   - N87# 23 b
   - N87# 24 b
   - M88# 7 a
   - N84# 11 c
   - M84# 7 d
   - M84# 8 c
   - M84# 9 d
   - M84# 10 d
   - M87# 5 a
   - N87# 19 b
   - M88# 15 c
   - M88# 11 a
   - M88# 12 c
   - N87# 16 d
   - N87# 17 d
   - M87# 18 c
   - M86# 51 d
   - M86# 52 b
   - M86# 53 c
   - M86# 54 a
   - M85# 14 b

B. Partnerships and Joint Ventures
   - M88# 1 b
   - N86# 59 a
   - N86# 60 d
   - M85# 1 d
   - M85# 2 b
   - M85# 3 a
   - M85# 5 c
   - N84# 14 a
   - N84# 15 d
   - M84# 1 a
   - M84# 2 a
   - M86# 55 b
   - M85# 11 b
   - M85# 12 d
   - M85# 58 b
   - M85# 58 d

III. Contracts

A. Offer and Acceptance
   - M87#16 a
   - N85# 11 d
   - B. Consideration
   - M88# 18 b
   - N87# 2 d
   - M87# 14 a
   - N84# 18 d
   - M87# 17 c
   - N84# 19 d
   - N86# 11 d
   - M88# 16 c
   - N86# 12 a
   - M85# 21 d
   - N86# 13 a
   - M86# 1 a
   - N84# 17 c
   - M87# 17 c
   - M87# 12 a
   - M86# 2 c
   - N84# 19 d
   - N86# 11 d
   - M87# 15 d
   - N85# 7 d
C. Capacity, Legality, and Public Policy

M88#19  a  N86#13  b  M85#18  b
  M87#18  a  N86#13  c  M86#14  d
  M86# 4  d  M86# 5  a  N84#20  c
  M84#11  c  M86# 8  b  M86#10  b

D. Statute of Frauds

M88#20  d  N85#15  c  M85#23  b
  M87#13  b  N86#16  a  M86# 6  a
  N85# 9  d  N84#21  d  N84#22  c

E. Statute of Limitations

M88#22  b  N85#17  c  M86# 7  c
  M85#24  d

F. Fraud, Duress, and Undue Influence

M88#25  c  N87# 4  a  M87#19  c
  M87#20  b  M86#19  d  M86#20  a
  M86# 8  b  M85#10  b
  N85#10  c  N85#15  c  M85#23  b

G. Mistake and Misrepresentation

N87# 5  a  M87#22  c

H. Parol Evidence Rule

M88#21  d  N86#22  d  M86#12  c
  N85#16  c  M85#25  c  N84#23  c

I. Third Party Rights

N84#25  d  M84#13  c

IV. Debtor-Creditor Relationships

A. Suretyship

M88#32  b  M84#21  c  M88#33  c
  M84#22  d  M88#34  a  M88#35  a
  M87#30  b  N85#30  a
  M87#31  c  N84#26  c
  M87#32  b  N84#27  b
  M87#29  a  M87#33  b  N84#28  d
  M86#26  b  M87#34  a  M84#16  b
  M86#27  a  M88#29  b  M87#35  b
  M86#28  c  M88#30  b  M84#18  a
  N85#31  c  M88#31  a  N86#29  d

B. Bankruptcy

M88#28  a  M88#27  a
  N86#26  b  N86#27  a
  M86#28  c

V. Government Regulation of Business

A. Regulation of Employment

N85#21  d  M88#42  b  N86#33  c
  N85#22  c  N87# 6  a  N86#34  b
  N85#30  d  N87# 7  c  N86#35  c
  M85#31  c  N87# 8  c  N86#36  b
  M84#37  b  N87# 9  d  M86#19  b
  N84#39  c  N87#10  c  M86#20  d
  N84#40  c  N87#11  b  M86#21  a
  M84#28  d  N87#12  b  M86#22  b
  M87#39  a  M87#39  c  M86#23  c

B. Federal Securities

M87#40  c  M87#41  b  M86#24  d
  M87#37  a  M87#42  d  M86#25  a
  M87#38  b  M87#43  b  N84#41  a
  N86#37  c  M87#44  a  N84#42  b
  N86#38  c  M87#45  b  N84#44  d
  N86#39  a  M88#36  c  N84#45  b
  M86#16  d  M88#37  a  M84#30  c
  M86#17  c  M88#38  a  M84#31  d
  M86#18  d  M88#39  c  M84#33  a
  M88#41  b  N86#32  d  M84#34  c
Unofficial Answers

VI. Uniform Commercial Code

A. Commercial Paper

<table>
<thead>
<tr>
<th>Reference</th>
</tr>
</thead>
</table>
| M88#46 | M85#36 d  
| M88#47 | M85#37 b  
| M88#48 | N87#40 d  
| N87#45 | M85#41 a  
| N87#46 | N85#46 c  
| N87#47 | N85#47 c  
| N87#48 | N85#48 c  
| N87#49 | N85#49 b  
| N87#50 | N86#50 a  
| N87#51 | N86#51 d  
| N87#52 | N86#52 b  
| N87#53 | N86#53 b  
| N87#54 | M86#54 a  
| N87#55 | M86#55 b  
| N87#56 | M86#56 d  
| N87#57 | M86#57 a  

B. Documents of Title and Investment Securities

<table>
<thead>
<tr>
<th>Reference</th>
</tr>
</thead>
</table>
| M88#49 | M85#42 c  
| N85#36 | M85#43 c  
| N85#37 | M85#44 c  
| N85#38 | M85#45 c  
| N85#39 | M85#46 c  
| N85#40 | M85#47 b  
| N85#41 | M85#48 b  
| N85#42 | M85#49 a  
| N85#43 | M85#50 a  
| N85#44 | M85#51 a  

C. Sales

<table>
<thead>
<tr>
<th>Reference</th>
</tr>
</thead>
</table>
| M85#53 | M85#52 d  
| M85#54 | M85#53 c  
| M85#55 | M85#54 c  

D. Secured Transactions

<table>
<thead>
<tr>
<th>Reference</th>
</tr>
</thead>
</table>
| M88#51 | M85#56 a  
| M88#52 | M85#57 d  
| N85#51 | M85#56 b  
| N85#52 | N86#51 d  
| N85#53 | M85#57 b  
| N85#54 | N86#52 c  
| N85#55 | N87#52 c  
| N85#56 | N87#51 d  
| N85#57 | N87#52 a  
| N87#53 | N86#53 b  
| N87#54 | M86#54 b  
| N87#55 | M86#55 b  
| N87#56 | M86#56 b  
| N87#57 | M86#57 b  

VII. Property

A. Real and Personal Property

<table>
<thead>
<tr>
<th>Reference</th>
</tr>
</thead>
</table>
| M86#51 | M88#57 b  
| M86#52 | M88#58 b  
| N87#51 | N85#51 d  
| M88#53 | M85#57 d  
| M88#54 | N87#52 c  
| M88#55 | N86#53 a  
| N87#53 | N86#54 b  
| N87#54 | M86#55 b  
| N87#55 | M86#56 b  
| N87#56 | M86#57 b  
| N87#57 | N86#56 d  
| N86#58 | N85#56 a  
| M86#59 | M85#59 d  
| M86#41 | M85#55 b  

C. Fire and Casualty Insurance

<table>
<thead>
<tr>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>M85#59</td>
</tr>
<tr>
<td>M86#59</td>
</tr>
</tbody>
</table>

B. Mortgages

<table>
<thead>
<tr>
<th>Reference</th>
</tr>
</thead>
</table>
| M88#52 | N85#56 a  
| M88#56 | M85#59 d  
| M85#55 | M85#60 b  

B-65
ESSAYS — SELECTED QUESTIONS

I. The CPA and the Law

M88
Number 5 (Estimated time — — 15 to 20 minutes)

Birk Corp. is interested in acquiring Apple & Co. Birk engaged Kaye & Co., CPAs, to audit the 1987 financial statements of Apple. Both Birk and Apple are engaged in the business of providing management consulting services. While reviewing certain contracts entered into by Apple, Kaye became concerned with the proper reporting of the following matters:

- On December 5, 1987, Apple entered into an oral agreement with Cream Inc., to perform certain management advisory services for Cream for a fee of $150,000 per month. The services were to have commenced on February 15, 1988, and to have ended on December 20, 1988. Apple reported all of the revenues related to the contract on its 1987 financial statements. This constituted 30% of Apple's income for 1987.

- On February 8, 1987, Apple purchased the assets of Nestar & Co., a small management consulting firm. Apple and Nestar entered into a written agreement with regard to the transaction that required Apple to pay Nestar $80,000 a year for five years. The agreement required Nestar to transfer all of its assets and goodwill to Apple. Further, the agreement required Nestar not to compete with Apple or Apple's successors for a period of three years within the city where the majority of Nestar's clients were located. Nestar's office was also located in this city. Other Nestar clients were located throughout the state.

On February 1, 1988, Birk acquired all of Apple's outstanding stock. Birk's decision was based on the unqualified opinion issued by Kaye on Apple's 1987 financial statements. Within 10 days after the merger, Cream decided not to honor the agreement with Apple and gave notice that it had selected another management consulting firm. This caused the market value of the Apple stock acquired by Birk to decrease drastically.

On May 2, 1987, Birk learned that Nestar opened a management consulting firm three blocks from where Nestar's office had been located on February 8, 1987.

Based on the foregoing, Birk has commenced an action against Kaye alleging negligence in performing the audit of Apple's financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss whether the December 5, 1987, agreement between Cream and Apple is enforceable.
b. Discuss whether the agreement of Nestar not to compete with Apple is enforceable against Nestar.

c. Discuss whether Birk will prevail in its action against Kaye & Co., CPAs.

M87
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?

M86
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.

- 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.

N85
Number 2 (Estimated time — 15 to 20 minutes)

Mason & Dilworth, CPAs, were the accountants for Monrad Corporation, a closely held corporation. Mason & Dilworth had been previously engaged by Monrad to perform certain compilation and tax return work. Crass, Monrad's president, indicated he needed something more than the previous type of services rendered. He advised Walker, the partner in charge, that the financial statements would be used internally, primarily for management purposes, and also to obtain short-term loans from financial institutions. Walker recommended that a review of the financial statements be performed. Walker did not prepare an engagement letter.

In the course of the review, Walker indicated some reservations about the financial statements. Walker indicated at various stages that "he was uneasy about certain figures and conclusions" but that "he would take the client's word about the validity of certain entries since the review was primarily for internal use in any event and was not an audit."

Mason & Dilworth did not discover a material act of fraud committed by management. The fraud would have been detected had Walker not relied wholly on the representations of management concerning the validity of certain entries about which he had felt uneasy.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. What is the role of the engagement letter when a CPA has agreed to perform a review of a closely held company? What points should be covered in a typical engagement letter which would be relevant to the parties under the facts set forth above?

b. What is the duty of the CPA in the event suspicious circumstances are revealed as a result of the review?

c. What potential liability does Mason & Dilworth face and who may assert claims against the firm?
Selected Questions

M85
Number 4 (Estimated time — — 15 to 20 minutes)

Arthur & Doyle, CPAs, served as auditors for Dunbar Corp. and Wolfe Corp., publicly held corporations listed on the American Stock Exchange. Dunbar recently acquired Wolfe Corp. pursuant to a statutory merger by issuing its shares in exchange for shares of Wolfe. In connection with that merger, Arthur & Doyle rendered an unqualified opinion on the financial statements and participated in the preparation of the pro forma unaudited financial statements contained in the combined prospectus and proxy statement circulated to obtain shareholder approval of the merger and to register the shares to be issued in connection with the merger. Dunbar prepared a form 8-K (the current report with unaudited financial statements) and form 10-K (the annual report with audited financial statements) in connection with the merger. Shortly thereafter, financial disaster beset the merged company which resulted in large losses to the shareholders and creditors. A class action suit on behalf of the shareholders and creditors has been filed against Dunbar and its management. In addition, it names Arthur & Doyle as co-defendants, challenging the fairness, accuracy, and truthfulness of the financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

As a result of the CPAs having expressed an unqualified opinion on the audited financial statements of Dunbar and Wolfe and as a result of having participated in the preparation of the unaudited financial statements required in connection with the merger, indicate and briefly discuss the various bases of the CPAs' potential civil liability to the shareholders and creditors of Dunbar under:

a. The federal securities acts.

b. State common law.

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?

II. Business Organizations

B. Partnerships and Joint Ventures

M88
Number 3 (Estimated time — — 15 to 20 minutes)

Walsh is evaluating two different investment opportunities. One requires an investment of $100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an investment of $100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

- The right of a limited partner versus that of a shareholder to participate in daily management.

- The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required: Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)

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.

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

Walsh is evaluating two different investment opportunities. One requires an investment of $100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an investment of $100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

- The right to transfer a limited partnership interest versus shares of stock.
- The liability as a limited partner versus that of a shareholder for debts incurred by a limited partnership or a corporation.
- The right of a limited partner versus that of a shareholder to participate in daily management.
- The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required: Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)
Selected Questions

N87
Number 5 (Estimated time — — 15 to 20 minutes)

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, 50c 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.

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.

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.

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
Business Law

1, 1987, which are fairly valued at $1,000. The promissory note has not been paid nor have the additional services been rendered.

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?
   - 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:

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 operation. White, a shareholder in Wonda, has properly commenced a suit against these directors.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss Wonda's and Bold's liability to Servco on the preincorporation agreements.

b. What are the necessary requirements to properly declare and pay cash dividends?

c. What defense(s) are available to the directors regarding the charges of negligence in the performance of their duties and the failure to exercise due care in declaring cash dividends?

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.
III. Contracts

b. Discuss whether the agreement of Nestar not to compete with Apple is enforceable against Nestar.

c. Discuss whether Birk will prevail in its action against Kaye & Co., CPAs.

N88
Number 5 (Estimated time —— 15 to 20 minutes)

Birk Corp. is interested in acquiring Apple & Co. Birk engaged Kaye & Co., CPAs, to audit the 1987 financial statements of Apple. Both Birk and Apple are engaged in the business of providing management consulting services. While reviewing certain contracts entered into by Apple, Kaye became concerned with the proper reporting of the following matters:

• On December 5, 1987, Apple entered into an oral agreement with Cream Inc., to perform certain management advisory services for Cream for a fee of $150,000 per month. The services were to have commenced on February 15, 1988 and to have ended on December 20, 1988. Apple reported all of the revenues related to the contract on its 1987 financial statements. This constituted 30% of Apple’s income for 1987.

• On February 8, 1987, Apple purchased the assets of Nestar & Co., a small management consulting firm. Apple and Nestar entered into a written agreement with regard to the transaction that required Apple to pay Nestar $80,000 a year for five years. The agreement required Nestar to transfer all of its assets and goodwill to Apple. Further, the agreement required Nestar not to compete with Apple or Apple’s successors for a period of three years within the city where the majority of Nestar’s clients were located. Nestar’s office was also located in this city. Other Nestar clients were located throughout the state.

On February 1, 1988, Birk acquired all of Apple’s outstanding stock. Birk’s decision was based on the unqualified opinion issued by Kaye on Apple’s 1987 financial statements. Within 10 days after the merger, Cream decided not to honor the agreement with Apple and gave notice that it had selected another management consulting firm. This caused the market value of the Apple stock acquired by Birk to decrease drastically.

On May 2, 1987, Birk learned that Nestar opened a management consulting firm three blocks from where Nestar’s office had been located on February 8, 1987.

Based on the foregoing, Birk has commenced an action against Kaye alleging negligence in performing the audit of Apple’s financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss whether the December 5, 1987, agreement between Cream and Apple is enforceable.

N87
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 counteroffer 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.
Business Law

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.

Number 3 (Estimated time — 15 to 20 minutes)

Jones signed an irrevocable 30-day option giving Lark the right to purchase a described tract of land owned by Jones at $20,000 per acre. Lark was a director of King Corporation and knew that King had purchased through a nominee the adjacent land and needed Jones' land in order to build its national headquarters. Lark did not disclose this information to Jones and hoped to make a profit from the option. Jones had heard that Lark was in personal financial trouble and believed Lark would be unable to raise the money to exercise the option. Furthermore, Jones had no intent to be bound by the option at the time he signed it. The option stated that it was given in exchange for $100 and other good and valid consideration but the $100 was not paid nor was there in fact any other consideration.

Ten days later Jones learned that Lark had granted an option to King to purchase Jones' land at $30,000 per acre. Lark tendered to Jones full cash payment at $20,000 per acre within the 30-day period. Jones refused to honor the option. Lark brings an action for specific performance of the option.

Jones asserts the following defenses:

- Lark breached his fiduciary duty to the King shareholders by personally entering into the 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.
Selected Questions

IV. Debtor-Creditor Relationships

B. Bankruptcy

N87

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. 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.

N85

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.

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.
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?

V. Government Regulation of Business

B. Federal Securities Acts

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?

VI. Uniform Commercial Code

A. Commercial Paper

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.
Selected Questions

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?

C. Sales

M88

Number 2 (Estimated time — 15 to 20 minutes)

Mirk & Co., CPAs, has been engaged to audit Spear Corp.'s 1987 financial statements. Spear is engaged in the business of buying and selling computers. Spear has adopted a calendar year for accounting purposes. While conducting the audit, Mirk reviewed the following transactions occurring in December 1987.

• On December 20, Spear sold five computers to Pica Corp. The contract required Spear to ship the computers by common carrier. The shipping terms of the contract were “F.O.B.—Spear’s loading dock.” The computers were shipped on December 30, and on January 1, 1988, while the computers were in transit, the common carrier was involved in an accident causing a fire that totally destroyed the computers. Pica discovered, upon a review of a copy of the common carrier's bill of lading, that the destroyed computers were not the models it had ordered.

• On December 21, Spear purchased and took delivery of 15 computers from Larson for $20,000. Larson had purchased the computers from Xeon Co., paying Xeon with a check that Larson's bank refused to honor because of insufficient funds. Spear was unaware that Larson's check was dishonored.

• On December 22, Spear entered into a sale on approval contract with Rusk Corp. for two computers. Rusk is engaged exclusively in the business of selling furniture. The contract required Rusk to notify Spear within 15 days after delivery if it did not want to keep the computers. Rusk took delivery of the computers on December 21, and, as of December 31, had not yet decided whether to keep the computers.

With regard to the transactions described above, Mirk wishes to resolve the following issues that were not addressed in the specific contracts:

As of December 31, 1987, which of the parties bears the risk of loss for the computers with regard to the:

• December 20 transaction with Pica?

• December 22 transaction with Rusk?

As of December 31, 1987, which of the parties has title to the computers with regard to the:

• December 21 transaction with Larson?

• December 22 transaction with Rusk?

What rights do the general creditors of Rusk have to the computers delivered to Rusk pursuant to the December 22 transaction with Spear?

Required: Discuss the issues raised by Mirk, setting forth your conclusions and reasons therefor.

N87

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.
Business Law

• 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.

N86

Number 3 (Estimated time — 15 to 20 minutes)

Finn, a junior member of the audit staff of a CPA firm, was assigned to assist the accountant-in-charge of the examination of the financial statements of Dark Manufacturing, Inc. Dark manufactures small motors and is located in Chicago. One facet of Finn's contribution to the examination of Dark is to examine the sales figures contained in the financial statements. Dark sells its motors to a broadly diversified range of buyers. The terms of the sales varied widely as to credit, delivery, security interests, and title. Finn remembered that one consideration in determining if a sale has taken place for accounting purposes is whether title to the goods has passed to the buyer. He also recalled that the Uniform Commercial Code's definition of a "sale" as "the passing of title from the seller to the buyer for a price." Finn examined the following representative samples of the types of transactions Dark enters into to determine whether they were in fact "sales":

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.

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.

N86

Number 3 (Estimated time — 15 to 20 minutes)

King Department Store is in the business of selling men's and ladies' apparel. Ward & Co., CPAs, while performing its year-end audit of King, reviewed the following agreements which King entered into with Lutz, its largest supplier of merchandise, in December, 1985:

• On December 24, 1985, King entered into a sale or return contract with Lutz. King received delivery of the goods on December 28, 1985.

• On December 26, 1985, King signed an agreement to purchase 20 fur coats from Lutz for $20,000. The contract required King to promptly pick up the goods at Lutz's warehouse. On December 31, 1985, King arrived at Lutz's warehouse, paying Lutz the $20,000. Lutz tendered delivery of the furs but King refused to take possession since its truck was experiencing mechanical difficulties. The following day, King arrived to pick up the coats and was informed that a fire destroyed the furs on December 31.

• On December 30, 1985, King entered into two contracts to purchase merchandise from Lutz. The contracts required that Lutz ship the goods by common carrier to King the following day, which it did. The shipping terms of the first contract were "F.O.B. King's Department Store." The second contract included the shipping term "C.I.F." (cost, insurance, and freight). Both shipments arrived at King's business on January 2, 1986.

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.
Selected Questions

- 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?

D. Secured Transactions

M88
Number 4 (Estimated time — 15 to 20 minutes)

Dunn & Co., CPAs, is auditing the 1987 financial statements of its client, Safe Finance. While performing the audit, Dunn learned of certain transactions that occurred during 1987 that may have an adverse impact on Safe's financial statements. The following transactions are of most concern to Dunn:

- On May 5, Safe sold certain equipment to Lux, who contemporaneously executed and delivered to Safe a promissory note and security agreement covering the equipment. Lux purchased the equipment for use in its business. On May 8, City Bank loaned Lux $50,000, taking a promissory note and security agreement from Lux that covered all of Lux's existing and afteracquired equipment. On May 11, Lux was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code and a trustee was appointed. On May 12, City filed a financing statement covering all of Lux's equipment. On May 14, Safe filed a financing statement covering the equipment it had sold to Lux on May 5.

- On July 10, Safe loaned $600,000 to Cam Corp., which used the funds to refinance existing debts. Cam duly executed and delivered to Safe a promissory note and a security agreement covering Cam's existing and after-acquired inventory of machine parts. On July 12, Safe filed a financing statement covering Cam's inventory of machine parts. On July 15, Best Bank loaned Cam $200,000. Contemporaneously with the loan, Cam executed and delivered to Best a promissory note and security agreement covering all of Cam's inventory of machine parts and any after-acquired inventory. Best had already
filed a financing statement covering Cam's inventory on June 20, after Best agreed to make the loan to Cam. On July 14, Dix, in good faith, purchased certain machine parts from Cam's inventory and received delivery that same day.

Required: Define a purchase money security interest. In separate paragraphs, discuss whether Safe has a priority security interest over:

- The trustee in Lux's bankruptcy with regard to the equipment sold by Safe on May 5.
- City with regard to the equipment sold by Safe on May 5.
- Best with regard to Cam's existing and after-acquired inventory of machine parts.
- Dix with regard to the machine parts purchased on July 14 by Dix.

N84
Number 4 (Estimated time — 15 to 20 minutes)

Tom Sauer purchased a computer and a stereo from Zen Sounds, Inc., for personal use. With regard to the computer, Sauer signed an installment purchase note and a security agreement. Under the terms of the note Sauer was to pay $100 down and $50 a month for 20 months. The security agreement included a description of the computer. However, Zen did not file a financing statement. Sauer paid $800 cash for the stereo.

Two months later, Sauer sold the computer to Ralph for $600 cash. Ralph purchased the computer for personal use without knowledge of Zen's security interest.

Three months later, Sauer brought the stereo back to Zen for repair. Inadvertently, one of Zen's 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?

VII. Property

A. Real and Personal Property

N84
Number 4 (Estimated time — 15 to 20 minutes)

Ted and his wife Judy own Redacre in a tenancy by the entirety. Redacre is a lot by the seaside on which they plan someday to build a summer home. Ted also owns Bigacre in a joint tenancy with Lois, Clark, and Jeff, each owning a ¼ undivided interest. Bigacre is a large parcel of investment acreage which produces no current income. Ted and Judy have had several arguments about the raising of their son Peter, now age 18, who Judy believes has exhibited a tendency toward irresponsibility. Ted, as a result, has decided to take certain steps on his own to protect Peter's future financial security.

Ted plans to establish a trust with Guardem Trust Company and Peter as co-trustees. He plans to transfer Redacre to the trust along with $100,000 in cash. The $100,000 is to be used to purchase Ted's interest in Bigacre. Although Judy knows of the steps being taken, she has not agreed to them. Accordingly, Ted does not plan to have her participate in the establishment of the trust or in any of the transactions or paperwork involved.

The trust will provide that all income is to be paid to Peter, with final distribution of all trust assets to Peter upon his reaching age 21. 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
Selected Questions

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.
SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. The CPA and the Law

M88
Answer 5 (10 points)

a. The December 5 oral agreement between Cream and Apple is unenforceable because the agreement failed to comply with the requirements of the statute of frauds. A contract that cannot possibly be performed within one year from the making of the contract falls within the provisions of the statute of frauds. As the facts clearly indicate, the December 5 oral agreement could not possibly be performed within one year of the making of the agreement (December 5, 1987) since the agreement required Apple to continue to perform until December 20, 1988. Therefore, the oral agreement is unenforceable.

b. The agreement between Nestar and Apple restricting Nestar from competing with Apple for three years within the city where Nestar’s office and the majority of Nestar’s clients were located is likely to be enforceable. An agreement not to compete will be enforceable if there has been a sale of a business including goodwill and the purpose of the restraint is to protect a property interest of the purchaser; the restraint is reasonable as to the geographic area covered; and the restraint is reasonable as to the time period. Under the facts of this case, the agreement not to compete is likely to be enforceable. The transaction involves the sale of Nestar’s management consulting business and goodwill. The purpose of the restraint is to protect the goodwill. The three year time period is reasonable. The limitation on the geographic area covered by the restraint to only the city where Nestar’s office and the majority of Nestar’s clients are located appears to be reasonable.

c. Birk will prevail in its action against Kaye based on negligence. Kaye owed a duty to Birk to conduct the audit with due care. Kaye failed to conduct the audit with due care by issuing an unqualified opinion on Apple’s 1987 financial statements when, in fact, Apple had made a material error by reporting all of the revenues related to the unenforceable December 5 agreement on its 1987 financial statements. Kaye’s issuance of an unqualified opinion despite the material error caused Birk to suffer damages as evidenced by the drastic decrease in the market value of Apple stock.

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 proceeding 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.

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 "uneasy about certain figures and conclusions." The CPA has an obvious duty to the client, Monrad, to inquire into any suspicious circumstances of which he becomes aware.

c. Depending on the circumstances about who in management was involved and their ownership of stock, Monrad in its own right may bring an action or the shareholders may bring a derivative action against Mason & Dilworth on behalf of the corporation for negligently failing to detect the fraud. It is possible that an action based upon constructive fraud might also be asserted against the firm because the conduct might be categorized as gross negligence or a reckless disregard for the truth. Certainly, a shareholder in his own right and any of the lending institutions will assert this and privity of contract will not be a valid defense.

There is authority supporting the rights of third party plaintiffs to sue and to recover from the accountants based upon a negligently performed review. As a general rule, third parties, even though not parties to the contract, may successfully assert negligence if they can show that they are members of a class of persons intended to benefit from the services performed by the CPA and that this was reasonably foreseeable by the CPA.

M85
Answer 4 (10 points)

a. The bases for shareholders' and creditors' suits against Arthur & Doyle under federal securities acts include

- That a violation of the 1933 Act has occurred as a result of misstatements or omissions in the prospectus or elsewhere in the registration statement required in order to "sell" the securities. The Securities and Exchange Commission has ruled that the issuance and exchange of stock pursuant to a
merger constitutes a "sale" within the meaning of the Securities Act of 1933.

- That a violation of the anti-fraud provisions of the 1934 act and of Rule 10b-5 issued pursuant thereto has occurred since misstatements and omissions of material facts may be fraudulent. Additionally, the anti-fraud provision (Sec. 17) of the 1933 act could be asserted.

- That a violation of the reporting requirements of the Securities Exchange Act of 1934 has occurred to the extent that false or misleading statements were included or material facts were omitted in the reports or other documents relating to the merger and which were filed with the SEC.

- That a violation of the proxy rules of the Securities Exchange Act of 1934 resulted from misstatements in or omissions from the merger proxy statement used in soliciting shareholder approval.

b. The bases for shareholders' and creditors' suits against Arthur & Doyle under state common law include

- Breach of contract. The relationship between Arthur & Doyle and Dunbar is contractual and requires that the CPAs' performance be rendered in a competent manner. The shareholders and creditors may claim breach of contract as third-party beneficiaries of the contract between the CPAs and Dunbar, since it could be held that the contract was entered into for their benefit and therefore they are in privity with the CPAs.

- Negligence. The shareholders and creditors could assert an independent claim of negligence in addition to the action for breach of contract. Negligence will be established when the CPAs fail to exercise reasonable care, taking into account such superior skill and knowledge the CPAs have or hold themselves out as having. Despite their lack of contractual privity, the shareholders and creditors will probably be able to successfully assert this action if they can show that they are members of a class of persons intended to benefit from the services performed by the CPAs and that this was reasonably foreseeable by the CPAs.

- Actual fraud or constructive fraud. Recent court decisions have substantially eroded the privity barrier faced by third parties. Arthur & Doyle may be held liable for actual fraud if it can be shown that they intentionally deceived the shareholders and creditors. Arthur & Doyle may be held liable for constructive fraud if there are deficiencies or lapses in their professional work of such a magnitude that they constitute gross negligence or a reckless disregard for the truth.

M84

Answer 2 (10 points)

1. Privity is an early common law concept that was adopted by the courts to prevent third parties from bringing a legal action based upon a contract to which they were not parties. William was in privity of contract with Perfect, its audit client, but William had no contractual relationship with Capitol despite Capitol's reliance upon the statements audited by William. Moreover, Capitol gave no consideration to William. Therefore, under strict application of the privity rule, Capitol lacks the standing to sue for breach of contract or negligence since Capitol is not in a direct contractual relationship with William.

Privy 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.
B. Partnerships and Joint Ventures

M88

Answer 3 (10 points)

A limited partnership is formed by two or more persons under a state’s limited partnership statute, having as members one or more general partners and one or more limited partners. Two or more persons desiring to form a limited partnership must execute a certificate of limited partnership that must be filed in the office of the secretary of state, or other appropriate state or local office. A corporation may be formed only under a state incorporation statute that requires that one or more incorporators sign articles of incorporation which must be filed with the secretary of state.

Unless otherwise provided in the partnership agreement, or other agreements among the partners, a limited partnership interest is assignable in whole or in part. Similarly, in the absence of a restriction in the corporation’s organizational documents or other agreements among the shareholders, shares of stock are freely transferable.

A limited partner’s liability for partnership debts is generally limited to the partner’s investment (capital contribution) in the partnership if the interest is fully paid and non-assessable and the partner does not participate in the daily management of the business. Likewise, a shareholder’s liability for a corporation’s debts is generally limited to the shareholder’s investment (capital contribution) in the corporation.

A limited partner cannot participate in the daily operations of the partnership’s business without losing limited liability. A shareholder who is not also an officer or a director cannot participate in the daily operations of the corporation’s business. However, a shareholder owning voting stock has the right to vote for a board of directors, which will manage the business affairs of the corporation. The board of directors selects officers to run the daily operations of the corporation.

A limited partner is entitled to receive a share of the partnership’s profits in the manner provided in the partnership agreement. On the other hand, whether a shareholder receives dividends is generally within the discretion of the board of directors.

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 distrib-
uted by the partnership. Since Stein and Wolf have refused to admit Simon as a partner, Simon will not be entitled to participate in the management of the partnership or to acquire Nolan’s right to possess specific partnership property.

b. Lemon’s first assertion that he is an agent coupled with an interest is incorrect. An agency coupled with an interest in the subject matter arises when the agent has an interest in the property that is the subject of the agency. The fact that Lemon entered into a two-year written agency agreement with the partnership that would pay Lemon a commission clearly will not establish an interest in the subject matter of the agency. The mere expectation of profits to be realized or proceeds to be derived from the sale of the partnership’s products is not sufficient to create an agency coupled with an interest. As a result, the principal-agency relationship may be terminated at any time.

Lemon’s second assertion that the principal-agency relationship may not be terminated without cause prior to the expiration of its term is incorrect. Where a principal-agency relationship is based upon a contract to engage the agent for a specified period of time, the principal may discharge the agent despite the fact such discharge is wrongful. Although the principal does not have the right to discharge the agent, he does have the power to do so. Thus, Lemon may be discharged without cause.

Lemon’s third assertion that he is entitled to damages because of the termination of the agency relationship is 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

M88 Answer 3 (10 points)

A limited partnership is formed by two or more persons under a state’s limited partnership statute, having as members one or more general partners and one or more limited partners. Two or more persons desiring to form a limited partnership must execute a certificate of limited partnership that must be filed in the office of the secretary of state, or other appropriate state or local office. A corporation may be formed only under a state incorporation statute that requires that one or more incorporators sign articles of incorporation which must be filed with the secretary of state.

Unless otherwise provided in the partnership agreement, or other agreements among the partners, a limited partnership interest is assignable in whole or in part. Similarly, in the absence of a restriction in the corporation’s organizational documents or other agreements among the shareholders, shares of stock are freely transferable.

A limited partner’s liability for partnership debts is generally limited to the partner’s investment (capital contribution) in the partnership if the interest is fully paid and non-assessable and the partner does not participate in the daily management of the business. Likewise, a shareholder’s liability for a corporation’s debts is generally limited to the shareholder’s investment (capital contribution) in the corporation.

A limited partner cannot participate in the daily operations of the partnership’s business without losing limited liability. A shareholder who is not also an officer or a director cannot participate in the daily operations of the corporation’s business. However, a shareholder owning voting stock has the right to vote for a board of directors, which will manage the business affairs of the corporation. The board of directors elects officers to run the daily operations of the corporation.

A limited partner is entitled to receive a share of the partnership’s profits in the manner provided in the partnership agreement. On the other hand, whether a shareholder receives dividends is generally within the discretion of the board of directors.
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 × $5 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 × 5% stock dividend = 2,000 shares × $5 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 × $5 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 50¢ per share would be reduced to 25¢ 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.

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 prohibits dividend distributions if, after giving effect to the distribution, the corporation’s total assets would be less than its total liabilities.

Answer 4 (10 points)

a. Generally, any person who is the 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.
mitted 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 respondeat 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:

\[
\begin{align*}
\text{First Acquisition} \\
\text{Total par value} &\times (1,000 \text{ shares} \times 10 \text{ par value}) &\quad \$10,000 \\
\text{Less: Consideration given (fair market} &\quad \text{value of property)} &\quad [3,500] \\
\text{Potential liability on first acquisition} &\quad \$ 6,500 \\

\text{Second Acquisition} \\
\text{Total par value} &\times (1,000 \text{ shares} \times 10 \text{ par value}) &\quad \$10,000 \\
\text{Less: Consideration given (services rendered)} &\quad [7,000] \\
\text{Potential liability on second acquisition} &\quad 3,000 \\
\text{Total Potential Liability} &\quad \$ 9,500
\end{align*}
\]

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 cir-
Business Law

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.

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 remainderman.

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.

III. Contracts

M88

Answer 5 (10 points)

a. The December 5 oral agreement between Cream and Apple is unenforceable because the agreement failed to comply with the requirements of the statute of frauds. A contract that cannot possibly be performed within one year from the making of the contract falls within the provisions of the statute of frauds. As the facts clearly indicate, the December 5 oral agreement could not possibly be performed within one year of the making of the agreement (December 5, 1987) since the agreement required Apple to continue to perform until December 20, 1988. Therefore, the oral agreement is unenforceable.

b. The agreement between Nestar and Apple restricting Nestar from competing with Apple for three years within the city where Nestar’s office and the majority of Nestar’s clients were located is likely to be enforceable. An agreement not to compete will be enforceable if there has been a sale of a business including goodwill and the purpose of the restraint is to protect a property interest of the purchaser; the restraint is reasonable as to the geographic area covered; and the restraint is reasonable as to the time period. Under the facts of this case, the agreement not to compete is likely to be enforceable. The transaction involves the sale of Nestar’s management consulting business and goodwill. The purpose of the restraint is to protect the goodwill. The three-year time period is reasonable. The limitation on the geographic area covered by the restraint to only the city where Nestar’s office and the majority of Nestar’s clients are located appears to be reasonable.

c. Birk will prevail in its action against Kaye based on negligence. Kaye owed a duty to Birk to conduct the audit with due care. Kaye failed to conduct the
audit with due care by issuing an unqualified opinion on Apple’s 1987 financial statements when, in fact, Apple had made a material error by reporting all of the revenues related to the unenforceable December 5 agreement on its 1987 financial statements. Kaye’s issuance of an unqualified opinion despite the material error caused Birk to suffer damages as evidenced by the drastic decrease in the market value of Apple stock.

N87
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 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, 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 offeree 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.

N84
Answer 3 (10 points)

Beach’s minority at the time the contract with Reid was entered into will not be a valid defense. Despite Beach’s misrepresentation of his age, the agreement with Reid was voidable at Beach’s option while Beach was a minor. However, Beach’s use and operation of the travel agency for at least seven months after reaching majority constituted an implied ratification of the contract. Some states may construe Beach’s mere failure to disaffirm the contract within a reasonable time after reaching majority to be a ratification of the contract. Furthermore, a small number of states provide that minority is not a defense where the minor has entered into a business contract.

Beach’s assertion that he is not liable due to Reid’s violation of the contract clause prohibiting Reid from competing with Beach is correct because violation of the non-competition covenant is a material breach of the contract. Since the case at issue involves the sale of a business including its goodwill, the legal validity of a clause prohibiting competition by the seller is determined by its reasonableness regarding the time and geographic area covered. Each case must be considered on its own facts, with a determination of what is reasonable under the particular circumstances. It appears that, according to the facts of this case, the prohibition against Reid’s operating a competing travel agency within a one mile radius of Beach’s travel agency for two years is reasonable.

Abel’s claim that he is not liable to Reid because of Beach’s fraud in supplying him with false financial statements is incorrect. Although a creditor has a duty to disclose to the surety all material facts that would increase the surety’s risk, the breach of such duty is not a valid defense of the surety if the creditor lacks knowledge of such facts. Therefore, unless Abel can show that Reid knew or had reason to know of the fraud committed by Beach, Abel will not be relieved of his surety undertaking.

Abel’s claim that he is not liable to Reid because of Beach’s minority is without merit. Beach’s minority is a personal defense that in a proper case may be exercised only at Beach’s option. Therefore, whether Beach has the power to disaffirm his contract with Reid will have no effect on Abel’s surety obligations to Reid.

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.

**M84**

**Answer 3** (10 points)

A corporate director's duty not to seize a corporate opportunity for himself is a duty owed to the corporation and may be enforced only by the corporation or its shareholders on its behalf. Breach of fiduciary duty by a director is not a valid defense in a contract action not involving the corporation.

Jones' assertion that Lark committed fraud will fail. Silence remains a viable defense to most claims of fraud. There are some instances where a duty to disclose is imposed, but these do not apply here. Nor is there any fiduciary or other obligation on Lark's part that would require disclosure to Jones.

The Statute of Frauds has been satisfied as there is a writing signed by the party to be charged (Jones).

Jones' unexpressed subjective intent not to be bound is irrelevant. The validity of the option is to be determined on the basis of what a reasonably prudent offeree would conclude was objectively intended.

The contract involves the sale of real property. Hence the common law applies, not the Uniform Commercial Code. The common law does not recognize the validity of an option unless supported by consideration or unless there has been a statutory change making such an option valid without consideration. A limited number of jurisdictions have adopted such a rule, but it remains a distinct minority rule. Despite the clause in the option that stated Jones was to receive "$100 and other valid consideration," no consideration was actually paid. Although the courts are willing to accept a formalized bargain with the recital of the consideration contained in the contract as long as it is paid or performed, they are unwilling to accept a fictional bargain, i.e., one which is merely recited.

Lark would be entitled to the remedy of specific performance if the option contract were valid. Land is unique in the eyes of the law, and such a remedy has traditionally been available for the breach of such a contract.

In conclusion, the option is not binding upon Jones since it is not supported by the requisite legal consideration necessary to form a valid option contract.

**IV. Debtor-Creditor Relationships**

**B. Bankruptcy**

**N87**

**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:

<table>
<thead>
<tr>
<th></th>
<th>Claim</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Able</td>
<td>$ 20,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Baker</td>
<td>$ 40,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Carr</td>
<td>$ 60,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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 surrender 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.

M85
Answer 5 (10 points)

The trustee in bankruptcy may properly avoid or set aside the payment made by Baker to Nix on May 17 since it meets all the requirements necessary to establish a preferential transfer. In order to establish a preference, the trustee must show that the transfer

- Was to or for the benefit of a creditor.
- Was made for or on account of an antecedent debt owed by the debtor before such transfer was made.
- Was made while the debtor was insolvent.
- Was made within 90 days prior to the filing of the petition (when the creditor is not an insider).
- Enables the creditor to receive more than such creditor would receive in a liquidation proceeding.

There is a rebuttable presumption that the debtor is insolvent during the ninety days preceding the filing of the petition.

The transfer made by Baker to Wax on June 6 may not be avoided or set aside by the trustee. Since the transfer was intended by Baker and Wax to be a contemporaneous exchange for new value given to Baker and was in fact a substantially contemporaneous exchange, the trustee may not avoid the transfer of the mortgage to Wax.

The payment made by Baker on June 16 for the electric bill may not be avoided by the trustee since the debt was incurred and paid in the ordinary course of Baker’s business, within forty-five days after the debt arose, and in accordance with ordinary business terms.

The trustee was correct by including in the estate rents and property received as a result of the final divorce decree. Generally, property acquired after the filing of a bankruptcy petition is not part of the debtor’s estate in bankruptcy but belongs to the debtor individually. However, there are certain exceptions to this
rule. One such exception is rents earned on property of the debtor's estate. Thus, the rents received from July 1 through November 1 will be included in Baker's estate. Another such exception is property received by the debtor as a result of a final divorce decree within 180 days of the filing of the bankruptcy petition. Thus, the receipt of property by Baker on October 10 as a result of a final divorce decree falls within the 180 days after the filing of the bankruptcy petition on July 1 and is therefore included in the debtor's estate.

V. Government Regulation of Business

B. Federal Securities Acts

N85
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.

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 indorsements 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 Uni-
form Commercial Code's Article on Commercial Paper which deals with "Imposters; Signature of Payee." In essence, this rule makes the indorsement 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 indorsements 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 forging 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.

C. Sales

M88

Answer 2 (10 points)

As of December 31, 1987, Spear bears the risk of loss for the computers on the December 20 contract with Pica. The shipping term "F.O.B.—Spear's loading dock" designates a shipment contract. In general, risk of loss passes to the buyer (Pica) in a shipment contract when the goods are duly delivered to the carrier. However, where a tender or delivery of goods so fails to conform to the contract as to give a right of rejection, the risk of their loss remains on the seller until cure or acceptance. Thus, the failure of the shipment to conform to the contract constitutes a breach that permits Pica to reject the computers, thereby resulting in Spear bearing the risk of loss for the computers while they are in transit.

With respect to the December 22 contract, the risk of loss as of December 31, 1987, remains with Spear. Unless otherwise agreed, the risk of loss in a sale on approval contract does not pass to the buyer until the buyer accepts the goods. Under the facts of this case, Rusk had not yet accepted the computers as of December 31, 1987. Therefore, the risk of loss on the computers as of December 31, 1987, remains with Spear.

As of December 31, 1987, Spear has title to the 15 computers purchased from Larson under the December 21 contract because a person with voidable title has the power to transfer good title to a good faith purchaser for value. Larson has voidable title because he paid for the computers with an insufficient funds check. Spear is a good faith purchaser for value because it paid Larson $20,000 and was unaware that Larson's check to Xeon was dishonored. The UCC Sales Article provides that when goods have been delivered under a transaction of purchase, the purchaser has the power to transfer good title even though the delivery was in exchange for a check that is later dishonored. Thus, Spear has good title to the computers as of December 31, 1987, despite Larson's check being dishonored, because it purchased and received the computers on December 21, 1987.

With respect to the December 22 sale on approval contract, title to the two computers remains with the seller until the buyer accepts the computers, because the contract is silent as to when title passes. Therefore, as of December 31, 1987, Spear retains title to the two computers because Rusk had not yet notified Spear whether it would accept the computers, and the time for such notification had not yet passed.

Because the December 22 contract between Spear and Rusk is a sale on approval contract, the computers are not subject to the claims of the creditors of the buyer (Rusk) until acceptance.

N87

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 needs 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.

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 lump 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 warranty, the plaintiff (Barr) must show:

- That the fork-lift was not fit for the ordinary purposes intended and
- That as a result of the breach of warranty, the plaintiff sustained a loss.

Strict Liability in Tort. Generally, the elements necessary to establish a cause of action based on strict liability in tort are as follows:

- That the product was in defective condition when it left the possession or control of the seller.
- That the product was unreasonably dangerous to the consumer or user.
- That the cause of the consumer’s or user’s injury was the defect.
- That the seller engaged in the business of selling such a product.
- That the product was one which the seller expected to and did reach the consumer or user without substantial changes in the condition in which it was sold.

Proof of fault is not a requirement to establish a cause of action in strict liability.

b. A proper disclaimer will permit the seller to exclude the implied warranty of merchantability. Under the facts, the disclaimer would appear to be invalid since a written disclaimer of the implied warranty of merchantability must be conspicuous and, arguably, the language in the contract is not acceptable under the UCC. In this case the disclaimer was in fine print and therefore not conspicuous. In addition, the disclaimer may be considered unconscionable since the contract was standardized and no bargaining of the terms of the contract was permitted. It should be pointed out that although consequential damages may be limited or excluded, in the case of consumer goods limitation of consequential damages for personal injuries is prima facie unconscionable. However, since the facts do not relate to consumer goods, such limitation of damages is not prima facie unconscionable but may be proved to be unconscionable.

N85 Answer 2 (10 points)

a. The sale of leather jackets is governed by the Uniform Commercial Code Sales Article which applies to transactions in goods. Under the Uniform Commercial Code, an oral contract for the sale of goods under $500 does not fall within the provisions of the statute of frauds. Thus, the contract between Reed and Rocco is enforceable by either party without the necessity of a signed writing since the sales price is $450. The UCC provides that an agreement to modify a contract for the sale of goods needs no consideration to be binding. However, the modification made must meet the test of good faith. The modification must also satisfy the requirements of the statute of frauds if the contract, as modified, falls within its provisions. Whether Reed acted in good faith is determined by an examination of the facts. Here, the shift in the market may satisfy the requirement of good faith if Reed can show that he would have suffered a loss had he sold the jackets at $450. However, if Reed refused to sell the jackets at $450 merely to derive a greater profit, with knowledge that Rocco was in immediate need of the goods, the modification may not meet the test of good faith.

Since the sales price increased from $450 to $550, the contract must satisfy the statute of frauds in order
Business Law

to be enforceable. The UCC statute of frauds may be satisfied by a confirmation if

- Both parties are merchants.
- It is in writing.
- The writing is signed by the sender.
- The writing states the quantity.
- The writing is received by the recipient within a reasonable time.
- The recipient has reason to know the contents of the writing.
- The recipient fails to give written notice of objection to its contents within ten days after receipt.

As the facts clearly indicate, the mailing of the signed letter by Reed to Rocco the day after the contract was orally modified, coupled with Rocco’s failure to object within ten days after receipt will satisfy the requirements of the statute of frauds.

b. No. As a general rule, a contract for the sale of real property must be supported by a written memo signed by the party to be charged. However, an oral contract to sell real property may be removed from the statute of frauds where there has been part performance and reasonable reliance on the oral contract. The part payment of the sales price by Reed, in addition to Reed’s taking possession of the building with Smith’s consent and making permanent and substantial improvements, generally will prevent Smith from setting the contract aside or requiring Reed to vacate the building.

D. Secured Transactions

N88

Answer 4 (10 points)

A purchase money security interest is an interest in personal property or fixtures that secures payment or performance of an obligation and that is (1) taken or retained by the seller of the collateral to secure all or part of its price, or (2) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

Safe’s security interest has priority over the rights of the trustee in bankruptcy. The UCC Article on Secured Transactions states that a lien creditor includes a trustee in bankruptcy from the date of the filing of the petition. Under the general rule, an unperfected security interest is subordinate to the rights of a person who becomes a lien creditor before the security interest is perfected. However, if the secured party files with respect to a purchase money security interest before or within 10 days after the debtor receives possession of the collateral, he takes priority over the rights of a lien creditor that arise between the time the security interest attaches and the time of filing. Under the facts of our case, Safe has a purchase money security interest in the equipment because the security interest was taken by Safe to secure the price. Therefore, because Safe filed a financing statement on May 14 (within 10 days after Lux received possession of the equipment) it has a priority security interest over the trustee in bankruptcy (lien creditor) whose claim arose between the time the security interest attached (May 5) and the time of filing (May 14). Safe has a priority security interest in the equipment over City. A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within 10 days thereafter. Because Safe has a purchase money security interest in the equipment that was perfected by filing a financing statement on May 14 (within 10 days after Lux received possession of the equipment on May 5), Safe has a priority security interest over City despite City’s perfection of its security interest on May 12.

Best’s security interest in the inventory has priority over Safe’s security interest. In general, conflicting perfected security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither a filing nor perfection. In this case, because both Best’s and Safe’s security interests were perfected by filing, the first to file (Best) will have a priority security interest. The fact that Best filed a financing statement prior to making the loan will not affect Best’s priority.

Safe will not have a priority security interest over Dix because Dix is a buyer in the ordinary course of business and will take free of Safe’s perfected security interest. Dix is a buyer in the ordinary course of business because Dix acted in good faith when purchasing the machine parts in the regular course of Cam’s business. The UCC Article on Secured Transactions states that a buyer in the ordinary course of business takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence. Therefore, Dix will take the machine parts purchased from Cam’s inventory on July 14, free from Safe’s security interest which was perfected on July 12.

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 acquiescing in the merchant’s retention of possession of the goods, must be the rightful owner in order for the merchant to acquire the power to transfer complete ownership and title. Since Sauer’s delivery of the stereo to Zen constituted an entrusting, Zen acquired the power to transfer title and ownership to Ned. Thus, upon Ned’s purchase of the stereo in good faith and without knowledge of Sauer’s true ownership interests, Ned acquired title to the stereo.

VII. Property

A. Real and Personal Property

M84

Answer 4 (10 points)

1. The trust will have no interest in Redacre but would have a one-quarter interest as tenant in common in Bigacre. The attempted transfer of Realty held as tenants by the entirety without the co-owner’s consent does not transfer the property. Therefore, Ted is unable to transfer any portion of Redacre since Judy has not consented to the transfer. A joint tenant may transfer his interest in the tenancy without the consent of the cotenants. However, such a transfer destroys the joint tenancy of the interest transferred. Therefore, the purchase of Ted’s interest in Bigacre gives the trust a one-quarter interest in the property as tenant in common with Clark, Lois, and Jeff remaining as joint tenants of three-quarters of the property.

2. Despite the trust’s one-quarter interest in Bigacre, it acquires no additional interest due to Clark’s death, since there is no right of survivorship with respect to a tenant in common. However, Jeff and Lois will acquire Clark’s one-quarter interest by operation of law, due to the right-of-survivorship feature among joint tenants. Therefore, Jeff and Lois will each own a three-eighths interest in Bigacre as joint tenants, whereas the trust will retain its one-quarter interest as a tenant in common.

3. A valid trust has been created. Ted, as grantor or settlor, has transferred property (res) to Guardem and Peter for the benefit of Peter. Intent to create a trust is evident, and the trust is established for a lawful purpose. It is proper for the sole beneficiary to act as cotrustee.

4. The trustees have a fiduciary duty to manage the trust for the benefit of the beneficiaries. In the absence of trust provisions otherwise, the trustees are required to invest in accordance with the standard of a prudent man in the conduct of his own investments. A trustee should ordinarily invest in income-producing property. However, the purchase of Bigacre by the trustees could meet this standard even though Bigacre is not currently earning income if the amount paid is fair and the future value may be expected to increase.

5. The trust would terminate and the interest in Bigacre would vest in Peter if he exercises his right to remove Guardem as trustee. As sole trustee Peter would hold legal title, and as sole beneficiary he would hold equitable title. A trust terminates when the sole beneficiary and sole trustee are the same person as legal and equitable title will be merged.

B. Mortgages

M84

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.


**CONTENTS**

**Examination in Accounting Practice — Part I**

<table>
<thead>
<tr>
<th>Question</th>
<th>N-2</th>
<th>Answer 1</th>
<th>N-56</th>
</tr>
</thead>
<tbody>
<tr>
<td>Question 2</td>
<td>N-5</td>
<td>Answer 2</td>
<td>N-56</td>
</tr>
<tr>
<td>Question 3</td>
<td>N-8</td>
<td>Answer 3</td>
<td>N-56</td>
</tr>
<tr>
<td>Question 4</td>
<td>N-11</td>
<td>Answer 4</td>
<td>N-57</td>
</tr>
<tr>
<td>Question 5</td>
<td>N-12</td>
<td>Answer 5</td>
<td>N-59</td>
</tr>
</tbody>
</table>

**Examination in Accounting Practice — Part II**

<table>
<thead>
<tr>
<th>Question 1</th>
<th>N-15</th>
<th>Answer 1</th>
<th>N-61</th>
</tr>
</thead>
<tbody>
<tr>
<td>Question 2</td>
<td>N-17</td>
<td>Answer 2</td>
<td>N-61</td>
</tr>
<tr>
<td>Question 3</td>
<td>N-19</td>
<td>Answer 3</td>
<td>N-61</td>
</tr>
<tr>
<td>Question 4</td>
<td>N-22</td>
<td>Answer 4</td>
<td>N-62</td>
</tr>
<tr>
<td>Question 5</td>
<td>N-23</td>
<td>Answer 5</td>
<td>N-64</td>
</tr>
</tbody>
</table>

**Examination in Auditing**

<table>
<thead>
<tr>
<th>Question 1</th>
<th>N-26</th>
<th>Answer 1</th>
<th>N-66</th>
</tr>
</thead>
<tbody>
<tr>
<td>Question 2</td>
<td>N-34</td>
<td>Answer 2</td>
<td>N-67</td>
</tr>
<tr>
<td>Question 3</td>
<td>N-34</td>
<td>Answer 3</td>
<td>N-67</td>
</tr>
<tr>
<td>Question 4</td>
<td>N-35</td>
<td>Answer 4</td>
<td>N-68</td>
</tr>
<tr>
<td>Question 5</td>
<td>N-35</td>
<td>Answer 5</td>
<td>N-68</td>
</tr>
</tbody>
</table>

**Examination in Business Law**

(Commercial Law)

<table>
<thead>
<tr>
<th>Question 1</th>
<th>N-37</th>
<th>Answer 1</th>
<th>N-70</th>
</tr>
</thead>
<tbody>
<tr>
<td>Question 2</td>
<td>N-45</td>
<td>Answer 2</td>
<td>N-71</td>
</tr>
<tr>
<td>Question 3</td>
<td>N-45</td>
<td>Answer 3</td>
<td>N-71</td>
</tr>
<tr>
<td>Question 4</td>
<td>N-46</td>
<td>Answer 4</td>
<td>N-72</td>
</tr>
<tr>
<td>Question 5</td>
<td>N-46</td>
<td>Answer 5</td>
<td>N-72</td>
</tr>
</tbody>
</table>

**Examination in Accounting Theory**

(Theory of Accounts)

<table>
<thead>
<tr>
<th>Question 1</th>
<th>N-48</th>
<th>Answer 1</th>
<th>N-73</th>
</tr>
</thead>
<tbody>
<tr>
<td>Question 2</td>
<td>N-54</td>
<td>Answer 2</td>
<td>N-74</td>
</tr>
<tr>
<td>Question 3</td>
<td>N-54</td>
<td>Answer 3</td>
<td>N-74</td>
</tr>
<tr>
<td>Question 4</td>
<td>N-55</td>
<td>Answer 4</td>
<td>N-75</td>
</tr>
<tr>
<td>Question 5</td>
<td>N-55</td>
<td>Answer 5</td>
<td>N-75</td>
</tr>
</tbody>
</table>

Suggested References .................................. N-76
Index ...................................................... N-81
NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>All questions are required:</th>
<th>Point Value</th>
<th>Estimated Minutes</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><strong>50</strong></td>
<td><strong>220</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. 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.
Examination Questions — November 1988

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:

Answer Sheet

97. [a] [o] [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. Burr Company had the following account balances at December 31, 1987:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash in banks</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>Cash on hand</td>
<td>125,000</td>
</tr>
<tr>
<td>Cash legally restricted for additions to plant</td>
<td>1,600,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$1,775,000</td>
</tr>
<tr>
<td>b.</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>c.</td>
<td>$2,375,000</td>
</tr>
<tr>
<td>d.</td>
<td>$3,975,000</td>
</tr>
</tbody>
</table>

2. Current assets should be

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$99,000</td>
</tr>
<tr>
<td>b.</td>
<td>$96,000</td>
</tr>
<tr>
<td>c.</td>
<td>$90,000</td>
</tr>
<tr>
<td>d.</td>
<td>$79,000</td>
</tr>
</tbody>
</table>

3. Noncurrent assets should be

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$130,000</td>
</tr>
<tr>
<td>b.</td>
<td>$134,000</td>
</tr>
<tr>
<td>c.</td>
<td>$136,000</td>
</tr>
<tr>
<td>d.</td>
<td>$140,000</td>
</tr>
</tbody>
</table>

4. Current liabilities should be

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$50,000</td>
</tr>
<tr>
<td>b.</td>
<td>$46,000</td>
</tr>
<tr>
<td>c.</td>
<td>$40,000</td>
</tr>
<tr>
<td>d.</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

5. Noncurrent liabilities including minority interests should be

<table>
<thead>
<tr>
<th>Option</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$115,000</td>
</tr>
<tr>
<td>b.</td>
<td>$109,000</td>
</tr>
<tr>
<td>c.</td>
<td>$104,000</td>
</tr>
<tr>
<td>d.</td>
<td>$ 55,000</td>
</tr>
</tbody>
</table>
6. Stockholders' equity should be
   a. $ 80,000
   b. $ 85,000
   c. $ 90,000
   d. $130,000

   ____________________________

   Items 7 through 9 are based on the following:

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

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

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

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

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

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

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

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

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

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

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

<table>
<thead>
<tr>
<th>Carrying amount</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $ 320,000</td>
<td>$ 320,000</td>
</tr>
<tr>
<td>Receivables 360,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Inventory 580,000</td>
<td>540,000</td>
</tr>
<tr>
<td>Property, plant and equipment 1,740,000</td>
<td>1,920,000</td>
</tr>
<tr>
<td>Liabilities (700,000)</td>
<td>(700,000)</td>
</tr>
<tr>
<td>Stockholders' equity $2,300,000</td>
<td>$2,440,000</td>
</tr>
</tbody>
</table>

   What is the amount of goodwill resulting from the business combination?
   a. $700,000
   b. $560,000
   c. $140,000
   d. $0

   12. On January 1, 1987, Kew Corp. incurred organization costs of $24,000. For financial accounting purposes, Kew is amortizing these costs on the same basis as the maximum allowable for Federal income tax purposes. What portion of the organization costs will Kew defer to years subsequent to 1987?
   a. $23,400
   b. $19,200
   c. $ 4,800
   d. $0
13. Dean Company's accounts payable balance at December 31, 1987 was $1,800,000 before considering the following transactions:

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

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

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

14. On January 15, 1988, Carr Corp. adopted a plan to accumulate funds for environmental improvements beginning July 1, 1992, at an estimated cost of $2,000,000. Carr plans to make four equal annual deposits in a fund that will earn interest at 10% compounded annually. The first deposit was made on July 1, 1988. Future value and future amount factors are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future value of 1 at 10% for 5 periods</td>
<td>1.61</td>
</tr>
<tr>
<td>Future amount of ordinary annuity of 1</td>
<td>4.64</td>
</tr>
<tr>
<td>at 10% for 4 periods</td>
<td></td>
</tr>
<tr>
<td>Future amount of annuity in advance of 1</td>
<td>5.11</td>
</tr>
<tr>
<td>at 10% for 4 periods</td>
<td></td>
</tr>
</tbody>
</table>

Carr should make four annual deposits (rounded) of:

a. $322,000
b. $391,400
c. $431,000
d. $500,000

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

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

16. Apex Company accepted from a customer a $100,000 face amount, 6-month, 8% note dated April 15, 1988. The same date Apex discounted the note at Union Bank at a 10% discount rate. How much cash should Apex receive from the bank on April 15, 1988?

a. $104,000
b. $99,000
c. $98,800
d. $97,200

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

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

What amount should Dell report as inventory in its December 31, 1987 balance sheet?

a. $1,175,000
b. $1,200,000
c. $1,235,000
d. $1,260,000

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

a. $18,460
b. $20,000
c. $23,075
d. $25,000

19. Kew Company recorded the following data pertaining to raw material X during January 1988:

<table>
<thead>
<tr>
<th>Date</th>
<th>Received</th>
<th>Cost</th>
<th>Issued</th>
<th>On hand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/88</td>
<td>Inventory</td>
<td>$4.00</td>
<td>1,600</td>
<td></td>
</tr>
<tr>
<td>1/11/88</td>
<td>Issue</td>
<td>800</td>
<td>800</td>
<td></td>
</tr>
<tr>
<td>1/22/88</td>
<td>Purchase</td>
<td>2,400</td>
<td>$4.80</td>
<td>3,200</td>
</tr>
</tbody>
</table>

The moving-average unit cost of X inventory at January 31, 1988, is:

a. $4.80
b. $4.60
c. $4.48
d. $4.40
Accounting Practice — Part I

20. At December 31, 1987, Raft Boutique had 1,000 gift certificates outstanding, which had been sold to customers during 1987 for $70 each. Raft operates on a gross margin of 60% of its sales. What amount of revenue pertaining to the 1,000 outstanding gift certificates should be deferred at December 31, 1987?
   a. $0
   b. $28,000
   c. $42,000
   d. $70,000

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. On December 31, 1987, Parke Corp. sold Edlow Corp. an airplane with an estimated remaining useful life of ten years. At the same time, Parke leased back the airplane for three years. Additional information is as follows:
   Sales price $600,000
   Carrying amount of airplane at date of sale $100,000
   Monthly rental under lease $6,330
   Interest rate implicit in the lease as computed by Edlow and known by Parke (this rate is lower than the lessee’s incremental borrowing rate) 12%
   Present value of operating lease rentals ($6,330 for 36 months @ 12%) $190,581
   The leaseback is considered an operating lease

In Parke’s December 31, 1987 balance sheet, what amount should be included as deferred revenue on this transaction?
   a. $0
   b. $190,581
   c. $309,419
   d. $500,000

22. On January 2, 1987, Ashe Company entered into a ten-year noncancellable lease as lessee, requiring annual payments of $200,000 payable at the beginning of each year. Ashe’s incremental borrowing rate is 14%, while the lessor’s implicit interest rate, known to Ashe, is 12%. Present value factors of an annuity of 1 in advance for ten periods are 6.33 at 12%, and 5.95 at 14%. The leased property has an estimated useful life of 12 years. Ownership of the property remains with the lessor at expiration of the lease. At the inception of the lease, Ashe should record a lease liability of
   a. $1,266,000
   b. $1,190,000
   c. $1,066,000
   d. $0

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

<table>
<thead>
<tr>
<th></th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service cost</td>
<td>$150,000</td>
<td>$165,000</td>
</tr>
<tr>
<td>Funding payment</td>
<td>170,000</td>
<td>185,000</td>
</tr>
<tr>
<td>Interest on projected benefit obligation</td>
<td>—</td>
<td>15,000</td>
</tr>
<tr>
<td>Actual return on plan assets</td>
<td>—</td>
<td>18,000</td>
</tr>
<tr>
<td>Experience gains or losses</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Rice chose early adoption of the FASB Statement on Employers' Accounting for Pensions. In its December 31, 1987 balance sheet, Rice should report prepaid pension cost of
   a. $20,000
   b. $25,000
   c. $40,000
   d. $43,000

24. Kemp Company purchased a patent on January 1, 1984, for $357,000. The patent was being amortized over its remaining legal life of 15 years expiring on January 1, 1999. During 1987 Kemp determined that the economic benefits of the patent would not last longer than ten years from the date of acquisition. What amount should be reported in the balance sheet as patent, net of accumulated amortization, at December 31, 1987?
   a. $261,800
   b. $252,000
   c. $244,800
   d. $214,200

25. In packages of its products, the Kent Food Company includes coupons which may be presented to grocers for discounts on certain products of Kent on or before a stated expiration date. The grocers are reimbursed when they send the coupons to Kent. In Kent’s experience, 40% of such coupons are redeemed, and one month generally elapses between the date a grocer receives a coupon from a consumer and the date Kent receives it. During 1987, Kent issued two series of coupons as follows:

<table>
<thead>
<tr>
<th>Issued on</th>
<th>Total value</th>
<th>Consumer expiration date</th>
<th>Amount disbursed as of 12/31/87</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/87</td>
<td>$100,000</td>
<td>6/30/87</td>
<td>$34,000</td>
</tr>
<tr>
<td>7/1/87</td>
<td>120,000</td>
<td>12/31/87</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Kent’s December 31, 1987 balance sheet should include a liability for unredeemed coupons of
   a. $0
   b. $8,000
   c. $14,000
   d. $48,000
Items 26 and 27 are based on the following:

On June 30, 1988, the condensed balance sheet for the partnership of Eddy, Fox, and Grimm, together with their respective profit and loss sharing percentages, was as follows:

<table>
<thead>
<tr>
<th>Assets, net of liabilities</th>
<th>$320,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eddy, capital (50%)</td>
<td>$160,000</td>
</tr>
<tr>
<td>Fox, capital (30%)</td>
<td>96,000</td>
</tr>
<tr>
<td>Grimm, capital (20%)</td>
<td>64,000</td>
</tr>
<tr>
<td>$320,000</td>
<td></td>
</tr>
</tbody>
</table>

26. Eddy decided to retire from the partnership and by mutual agreement is to be paid $180,000 out of partnership funds for his interest. Total goodwill implicit in the agreement is to be recorded. After Eddy's retirement, what are the capital balances of the other partners?

<table>
<thead>
<tr>
<th>Fox</th>
<th>Grimm</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $84,000</td>
<td>$56,000</td>
</tr>
<tr>
<td>b. $102,000</td>
<td>$68,000</td>
</tr>
<tr>
<td>c. $108,000</td>
<td>$72,000</td>
</tr>
<tr>
<td>d. $120,000</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

27. Assume instead that Eddy remains in the partnership and that Hamm is admitted as a new partner with a 25% interest in the capital of the new partnership for a cash payment of $140,000. Total goodwill implicit in the transaction is to be recorded. Immediately after admission of Hamm, Eddy's capital account balance should be

a. $280,000
b. $210,000
c. $160,000
d. $140,000

29. On December 31, 1986, Evan Company leased a machine from Ryan for a ten-year period expiring December 30, 1996. Equal annual payments under the lease are $100,000 and are due on December 31 of each year. The first payment was made on December 31, 1986, and the second payment was made on December 31, 1987. The present value at December 31, 1986, of the ten lease payments over the lease term discounted at 10% was $676,000. The lease is appropriately accounted for as a capital lease by Evan. In its December 31, 1987 balance sheet, Evan should report a total lease liability of

a. $800,000
b. $643,600
c. $533,600
d. $518,400

30. During 1986, Ward 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, 1986 and 1987, are as follows:

<table>
<thead>
<tr>
<th>Sales</th>
<th>Actual warranty expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>$300,000</td>
</tr>
<tr>
<td>1987</td>
<td>500,000</td>
</tr>
<tr>
<td>$800,000</td>
<td>$19,500</td>
</tr>
</tbody>
</table>

At December 31, 1987, Ward would report an estimated warranty liability of

a. $28,500
b. $22,500
c. $8,500
d. $5,000

31. On October 1, 1987, Yost Corp. acquired for cash all of the voting common stock of Leer, Inc. The purchase price of Leer's stock equaled the book value and fair value of Leer's net assets. The separate net income for each company, excluding Yost's share of income from Leer, was as follows:

<table>
<thead>
<tr>
<th></th>
<th>Yost</th>
<th>Leer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Twelve months ended</td>
<td>$1,500,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Three months ended 12/31/87</td>
<td>165,000</td>
<td>150,000</td>
</tr>
</tbody>
</table>

During September, Leer paid $450,000 in dividends to its stockholders. For the year ended December 31, 1987, Yost Corp. issued parent company only financial statements. These statements are not considered to be those of the primary reporting entity. Under the equity method, what is the amount of net income reported in Yost's income statement?

a. $2,400,000
b. $1,950,000
c. $1,725,000
d. $1,650,000
32. On March 1, 1988, Case Corp. issued $1,000,000 of 10% nonconvertible bonds at 103, due on February 28, 1998. Each $1,000 bond was issued with 30 detachable stock warrants, each of which entitled the holder to purchase, for $50, one share of Case common stock, par value $25. On March 1, 1988, the quoted market value of each warrant was $4. What amount of the bond issue proceeds should Case record as an increase in stockholders’ equity?
   a. $120,000
   b. $90,000
   c. $30,000
   d. $0

33. In its accrual basis income statement for the year ended December 31, 1987, Glen Corp. reported revenue of $1,550,000. Additional information was as follows:

   Accounts receivable — December 31, 1986  $350,000
   Accounts receivable — December 31, 1987  $550,000

   Under the cash basis, how much should Glen report as revenue for 1987?
   a. $1,000,000
   b. $1,200,000
   c. $1,350,000
   d. $1,750,000

34. Lewis Company’s usual sales terms are net 60 days, F.O.B. shipping point. Sales, net of returns and allowances, totaled $2,300,000 for the year ended December 31, 1987, before year-end adjustments. Additional data are as follows:
   - On December 27, 1987, Lewis authorized a customer to return, for full credit, goods shipped and billed at $50,000 on December 15, 1987. The returned goods were received by Lewis on January 4, 1988, and a $50,000 credit memo was issued and recorded on the same date.
   - Goods with an invoice amount of $80,000 were billed and recorded on January 3, 1988. The goods were shipped on December 30, 1987.
   - Goods with an invoice amount of $100,000 were billed and recorded on December 30, 1987. The goods were shipped on January 3, 1988.

   Lewis’ adjusted net sales for 1987 should be
   a. $2,330,000
   b. $2,280,000
   c. $2,250,000
   d. $2,230,000

35. Hill Company began operations on January 1, 1987, and appropriately uses the installment method of accounting. Data available for 1987 are as follows:

   Installment accounts receivable, 12/31/87  $500,000
   Installment sales 900,000
   Cost of goods sold, as percentage of sales 60%

   Using the installment method, Hill’s realized gross profit for 1987 would be
   a. $360,000
   b. $240,000
   c. $200,000
   d. $160,000

36. On January 1, 1986, Mill Company sold a building and received as consideration $100,000 cash and a $400,000 noninterest bearing note due on January 1, 1989. There was no established exchange price for the building, and the note had no ready market. The prevailing rate of interest for a note of this type at January 1, 1986, was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Mill’s 1987 income statement?
   a. $44,000
   b. $40,000
   c. $33,333
   d. $33,000

37. Dix Company acquired 2,000 shares of Lane, Inc. common stock on October 5, 1985, at a cost of $44,000. On April 10, 1987, Lane distributed a 10% common stock dividend when the market price of the stock was $30 per share. On December 20, 1987, Dix sold 200 shares of its Lane stock for $6,400. For the year ended December 31, 1987, what amount should Dix report as dividend revenue?
   a. $0
   b. $2,400
   c. $6,000
   d. $6,400

38. On January 1, 1988, Ott Company sold goods to Fox Company. Fox signed a noninterest-bearing note requiring payment of $60,000 annually for seven years. The first payment was made on January 1, 1988. The prevailing rate of interest for this type of note at date of issuance was 10%. Information on present value factors is as follows:

   Periods       | Present value of 1 at 10% | Present value of ordinary annuity of 1 at 10%
   -----------   | --------------           | --------------------------
   6           | .56             | 4.36                      |
   7           | .51             | 4.87                      |

   Ott should record sales revenue in January 1988 of
   a. $321,600
   b. $292,200
   c. $261,600
   d. $214,200
39. Ray Corp. has $300,000 convertible 8% bonds outstanding at June 30, 1988. Each $1,000 bond is convertible into 10 shares of Ray’s $50 par value common stock. On July 1, 1988, the interest was paid to bondholders, and the bonds were converted into common stock which had a fair market value of $75 per share. The unamortized premium on these bonds payable is $6,000 at the date of conversion. Under the book value method, this conversion increases the following elements of the stockholders’ equity section by

<table>
<thead>
<tr>
<th>Common stock</th>
<th>Additional paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $300,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>b. $225,000</td>
<td>$81,000</td>
</tr>
<tr>
<td>c. $153,000</td>
<td>$153,000</td>
</tr>
<tr>
<td>d. $150,000</td>
<td>$156,000</td>
</tr>
</tbody>
</table>

   a. $92,000
   b. $142,000
   c. $150,000
   d. $192,000

42. During 1987, Kerr Company sold a parcel of land used as a plant site. The amount Kerr received was $100,000 in excess of the land’s carrying amount. Kerr’s income tax rate for 1987 was 30%. In its 1987 income statement, Kerr should report a gain on sale of land of
   a. $0
   b. $30,000
   c. $70,000
   d. $100,000

43. The following information is available for Mason Corp. for 1987:
   - Sales $100,000
   - Beginning inventory 36,000
   - Ending inventory 19,000
   - Freight out 9,000
   - Purchases 43,000

   Mason’s cost of goods sold for 1987 is
   a. $52,000
   b. $60,000
   c. $69,000
   d. $88,000

44. Day Corp. holds 10,000 shares of its $10 par value common stock as treasury stock reacquired in 1986 for $120,000. On December 12, 1988, Day reissued all 10,000 shares for $190,000. Under the cost method of accounting for treasury stock, the reissuance would result in a credit to
   a. Capital stock of $100,000
   b. Retained earnings of $70,000
   c. Gain on sale of investments of $70,000
   d. Additional paid-in capital of $70,000

45. On October 1, 1987, Burns Corp. approved a formal plan to sell Hall division, a business segment. The sale was scheduled to take place on March 31, 1988. Hall had operating income of $100,000 for the quarter ended December 31, 1987, and expected to incur an operating loss of $50,000 for the first quarter of 1988. Burns estimated that it would incur a $375,000 loss on the sale of Hall’s assets. Burns’ income tax rate for 1987 was 30%. In its 1987 income statement, Burns should report a loss on the disposal of Hall division of
   a. $325,000
   b. $297,500
   c. $262,500
   d. $227,500

46. During the second quarter of 1988, Buzz Company sold a piece of equipment at a $12,000 gain. What portion of the gain should Buzz report in its income statement for the second quarter of 1988?
   a. $12,000
   b. $6,000
   c. $4,000
   d. $0
47. Burl Company incurred the following loss and realized the following gain during 1987:

- $50,000 loss as the result of an unanticipated strike by its employees.
- $25,000 gain as the result of the early extinguishment of bonds payable.

Burl’s income tax rate for 1987 was 30%. Burl’s 1987 income statement should report an extraordinary loss and an extraordinary gain of

<table>
<thead>
<tr>
<th>Extraordinary loss</th>
<th>Extraordinary gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $0</td>
<td>$17,500</td>
</tr>
<tr>
<td>c. $35,000</td>
<td>$0</td>
</tr>
<tr>
<td>d. $35,000</td>
<td>$17,500</td>
</tr>
</tbody>
</table>

48. At December 31, 1987, Tara Corp.’s stockholders’ equity consisted of the following:

Preferred stock, $100 par, 10% noncumulative; 10,000 shares authorized, issued, and outstanding $1,000,000
Common stock, $20 par; 100,000 shares authorized; 80,000 shares issued and outstanding 1,600,000
Retained earnings 600,000

The preferred stock has a liquidating value of $110 a share. At December 31, 1987, the book value per share of common stock is

- a. $20.00
- b. $22.00
- c. $26.25
- d. $27.50

49. The following information is available from Timber Corp.’s financial records for 1987:

**Sales**
- Net credit sales $500,000
- Net cash sales 250,000

**Accounts Receivable**
- Balance, January 1, 1987 $ 75,000
- Balance, December 31, 1987 50,000

How many times did Timber’s accounts receivable turn over in 1987?

- a. 15
- b. 12
- c. 10
- d. 8

50. During 1987, Moore Corp. had the following two classes of stock issued and outstanding for the entire year:

- 100,000 shares of common stock, $1 par.
- 1,000 shares of 4% preferred stock, $100 par, convertible share for share into common stock. This stock is not a common stock equivalent.

Moore’s 1987 net income was $900,000, and its income tax rate for the year was 30%. In the computation of primary earnings per share for 1987, the amount to be used in the numerator is

- a. $896,000
- b. $898,800
- c. $900,000
- d. $901,200

51. During 1987, Jones Company engaged in the following transactions:

- Salary expense to key employees who are also principal owners $100,000
- Sales to affiliated enterprises 250,000

Which of the two transactions would be disclosed as related party transactions in Jones’s 1987 financial statements?

- a. Neither transaction.
- b. The $100,000 transaction only.
- c. The $250,000 transaction only.
- d. Both transactions.

52. At December 31, 1987, Jannis Corp. owned two assets as follows:

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current cost $100,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Recoverable amount $ 95,000</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

Jannis voluntarily disclosed supplementary information about current cost at December 31, 1987. In such a disclosure, at what amount would Jannis report total assets?

- a. $175,000
- b. $180,000
- c. $185,000
- d. $190,000

53. In October 1987, Swine Corp. filed a lawsuit seeking $100,000 in damages for alleged copyright infringement. On December 31, 1987, with the case still in progress, Swine’s attorney asserted that Swine would probably win the suit, but would likely receive $80,000 in damages. On February 1, 1988, before Swine’s 1987 financial statements were issued, the suit was settled out of court for $60,000. In its December 31, 1987 financial statements, Swine should report accrued revenue of

- a. $0
- b. $ 60,000
- c. $ 80,000
- d. $100,000
54. The following information relates to the 1987 activity of the defined benefit pension plan of Lindy Corp., a company whose stock is publicly traded:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service cost</td>
<td>$150,000</td>
</tr>
<tr>
<td>Return on plan assets</td>
<td>40,000</td>
</tr>
<tr>
<td>Interest cost on pension benefit obligation</td>
<td>82,000</td>
</tr>
<tr>
<td>Amortization of actuarial loss</td>
<td>15,000</td>
</tr>
<tr>
<td>Amortization of unrecognized net obligation</td>
<td>35,000</td>
</tr>
</tbody>
</table>

Lindy’s 1987 pension cost is
a. $322,000  
b. $287,000  
c. $242,000  
d. $158,000  

55. On July 2, 1988, Creighton Corp. was formed for the purpose of presenting a musical comedy show. The show was scheduled to be presented only on December 30, 1988. A total of 1,000 tickets were sold between July 2 and December 30, including 50 tickets sold between July 2 and July 31. During July, Creighton paid $12,000 in salaries to actors involved in rehearsals during that month. On July 31, Creighton was considered to be in the development stage of its principal operation. In an income statement prepared for the period July 2 through July 31, 1988, Creighton should report salary expense of
a. $0  
b. $600  
c. $2,000  
d. $12,000  

56. Howe, Inc. was organized to consolidate the resources of Ball Corp. and Cook Corp. in a business combination appropriately accounted for by the pooling of interests method. On January 1, 1988, Howe issued 60,000 shares of its $10 par value common stock for all of the outstanding capital stock of Ball and Cook. The equity account balances of Ball and Cook on this date were:

<table>
<thead>
<tr>
<th></th>
<th>Ball</th>
<th>Cook</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Par value of common stock</td>
<td>$150,000</td>
<td>$400,000</td>
<td>$550,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>30,000</td>
<td>85,000</td>
<td>115,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>100,000</td>
<td>215,000</td>
<td>315,000</td>
</tr>
<tr>
<td></td>
<td>$280,000</td>
<td>$700,000</td>
<td>$980,000</td>
</tr>
</tbody>
</table>

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

57. On January 1, 1987, Apex Company, whose stock is publicly traded, had 100,000 shares of common stock issued and outstanding. On April 1, 1987, Apex issued a 10% stock dividend. The number of shares to be used in the computation of earnings per share for 1987 is
a. 100,000  
b. 105,000  
c. 107,500  
d. 110,000  

58. At December 31, 1987, Spud Corp. owned 80% of Jenkins Corp.’s common stock and 90% of Thompson Corp.’s common stock. Jenkins’ 1987 net income was $100,000 and Thompson’s 1987 net income was $200,000. Thompson and Jenkins had no intercompany ownership or transactions during 1987. Combined 1987 financial statements are being prepared for Thompson and Jenkins in contemplation of their sale to an outside party. In the combined income statement, combined net income should be reported at
a. $210,000  
b. $260,000  
c. $280,000  
d. $300,000  

59. On December 31, 1987, Shane is a fully-vested participant in a company-sponsored pension plan. According to the plan’s administrator, Shane has at that date the nonforfeitable right to receive a lump sum of $100,000 on December 28, 1988. The discounted amount of $100,000 is $90,000 at December 31, 1987. The right is not contingent on Shane’s life expectancy and requires no future performance on Shane’s part. In Shane’s December 31, 1987 personal statement of financial condition, the vested interest in the pension plan should be reported at
a. $0  
b. $90,000  
c. $95,000  
d. $100,000  

60. Bain Corp. owned 20,000 common shares of Tell Corp., purchased in 1983 for $180,000. On December 15, 1987, Bain declared a property dividend of all of its Tell Corp. shares on the basis of one share of Tell for every 10 shares of Bain common stock held by its stockholders. The property dividend was distributed on January 15, 1988. On the declaration date, the aggregate market price of the Tell shares held by Bain was $300,000. The entry to record the declaration of the dividend would include a debit to retained earnings (or property dividends declared) of
a. $0  
b. $120,000  
c. $180,000  
d. $300,000  

N-10
Accounting Practice — Part 1

Number 4 (Estimated time — 45 to 55 minutes)

At December 31, 1986, Cord Company's plant asset and accumulated depreciation and amortization accounts had balances as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>Plant asset</th>
<th>Accumulated depreciation and amortization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$175,000</td>
<td>$—</td>
</tr>
<tr>
<td>Buildings</td>
<td>1,500,000</td>
<td>328,900</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,125,000</td>
<td>317,500</td>
</tr>
<tr>
<td>Automobiles and trucks</td>
<td>172,000</td>
<td>100,325</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>216,000</td>
<td>108,000</td>
</tr>
<tr>
<td>Land improvements</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Depreciation methods and useful lives

- Buildings — 150% declining balance; 25 years.
- Machinery and equipment — Straight-line; 10 years.
- Automobiles and trucks — 150% declining balance; five years, all acquired after 1983.
- Leasehold improvements — Straight-line.
- Land improvements — Straight-line.

Depreciation is computed to the nearest month.
The salvage values of the depreciable assets are immaterial.

Transactions during 1987 and other information

- On January 6, 1987, a plant facility consisting of land and building was acquired from King Corp., in exchange for 25,000 shares of Cord’s common stock. On this date, Cord’s stock had a market price of $50 a share. Current assessed values of land and building for property tax purposes are $187,500 and $562,500, respectively.
- On March 25, 1987, new parking lots, streets, and sidewalks at the acquired plant facility were completed at a total cost of $192,000. These expenditures had an estimated useful life of 12 years.
- The leasehold improvements were completed on December 31, 1983, and had an estimated useful life of eight years. The related lease, which would have terminated on December 31, 1989, was renewable for an additional four-year term. On April 29, 1987, Cord exercised the renewal option.
- On July 1, 1987, machinery and equipment were purchased at a total invoice cost of $325,000. Additional costs of $10,000 for delivery and $50,000 for installation were incurred.
- On September 30, 1987, a truck with a cost of $24,000 and a carrying amount of $9,100 on date of sale was sold for $11,500. Depreciation for the 9 months ended September 30, 1987 was $2,650.

Number 4 (continued)

- On December 20, 1987, a machine with a cost of $17,000 and a carrying amount of $2,975 at date of disposition was scrapped without cash recovery.

Required:

a. Prepare a schedule analyzing the changes in each of the plant asset accounts during 1987. This schedule should include columns for beginning balance, increase, decrease and ending balance for each of the plant asset accounts. Do not analyze changes in accumulated depreciation and amortization accounts.

b. For each asset category, prepare a schedule showing depreciation or amortization expense for the year ended December 31, 1987. Round computations to the nearest whole dollar.
Number 5 (Estimated time — 40 to 50 minutes)

Peel, Inc., acquired all of the outstanding $25 par value common stock of Stagg, Inc., on June 30, 1987, in exchange for 40,000 shares of its $25 par value common stock. The business combination meets all conditions for a pooling of interests. On June 30, 1987, Peel’s common stock closed at $65 per share on a national stock exchange. Both corporations continued to operate as separate businesses maintaining separate accounting records with years ending December 31.

On December 31, 1987, after year-end adjustments and closing nominal accounts, the companies had condensed balance sheet accounts as follows:

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Peel</th>
<th>Stagg</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$925,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Accounts and other</td>
<td></td>
<td></td>
</tr>
<tr>
<td>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>600,000</td>
<td>330,000</td>
</tr>
<tr>
<td>Depreciable assets, net</td>
<td>4,525,000</td>
<td>1,980,000</td>
</tr>
<tr>
<td>Investment in Stagg, Inc.</td>
<td>2,430,000</td>
<td></td>
</tr>
<tr>
<td>Long-term investments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>and other assets</td>
<td>865,000</td>
<td>385,000</td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
</tr>
</tbody>
</table>

| Liabilities and          | Peel    | Stagg  |
| Stockholders’ Equity:    |         |        |
| Accounts payable and     |         |        |
| other current liabilities| $2,465,000| $1,145,000|
| Long-term debt           | 1,900,000| 1,300,000|
| Common stock, $25 par     | 3,200,000| 1,000,000|
| value                    |         |        |
| Additional paid-in capital| 1,850,000| 190,000|
| Retained earnings        | 4,380,000| 1,240,000|
|                         | $13,795,000| $4,875,000|

Additional information is as follows:

- Peel uses the equity method of accounting for its investment in Stagg. The investment in Stagg has not been adjusted for any intercompany transactions.

- On June 30, 1987, Stagg’s assets and liabilities had fair values equal to the book balances with the exception of land, which had a fair value of $550,000.

- On June 15, 1987, Stagg paid a cash dividend of $4 per share on its common stock.

- On December 10, 1987, Peel paid a cash dividend totaling $256,000 on its common stock.

- On June 30, 1987, immediately before the combination, the stockholders’ equities were:

<table>
<thead>
<tr>
<th>Peel</th>
<th>Stagg</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></td>
<td>$6,896,000</td>
</tr>
</tbody>
</table>

- Stagg’s long-term debt consisted of 10% ten-year bonds issued at face value on March 31, 1981. Interest is payable semiannually on March 31 and September 30. Peel had purchased Stagg’s bonds at face value of $320,000 in 1981, and there was no change in ownership through December 31, 1987.

- During October 1987 Peel sold merchandise to Stagg at an aggregate invoice price of $720,000, which included a profit of $180,000. At December 31, 1987, one-half of the merchandise remained in Stagg’s inventory, and Stagg had not paid Peel for the merchandise purchased.

- Stagg’s 1987 net income was $580,000. Peel’s 1987 income before considering equity in Stagg’s net income was $890,000.

- The balances in retained earnings at December 31, 1986, were $2,506,000 and $820,000 for Peel and Stagg, respectively.

Required:

Go to page 13 and remove tear-out worksheet.

a. Complete the tear-out worksheet to prepare a consolidated balance sheet of Peel, Inc., and its subsidiary, Stagg, Inc., at December 31, 1987. A formal consolidated balance sheet and journal entries are not required. Include the completed tear-out worksheet in the proper sequence with other answer sheets.

Peel, Inc. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1987

<table>
<thead>
<tr>
<th></th>
<th>Peel, Inc.</th>
<th>Stagg, Inc.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$925,000</td>
<td>$300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts and 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>600,000</td>
<td>330,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciable assets, net</td>
<td>4,525,000</td>
<td>1,980,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Stagg, Inc.</td>
<td>2,430,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term investments and other assets</td>
<td>865,000</td>
<td>385,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets:</strong></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td></td>
</tr>
<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>$2,465,000</td>
<td>$1,145,000</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 value</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><strong>Total Liabilities and stockholders’ equity:</strong></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
EXAMINATION IN ACCOUNTING PRACTICE — PART II

November 3, 1988; 1:30 P.M. to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>All questions are required:</th>
<th>Point Value</th>
<th>Estimated Minutes</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>Total</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. 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.
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:

Answer Sheet

97. □ □ □ □

Number 1 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to the federal taxation of individuals, estates, and trusts. The answers should be based on the Internal Revenue Code and Tax Regulations in effect for the tax period specified in the item. If no tax period is specified, use the current Internal Revenue Code and Tax Regulations.

Items to be Answered

1. Blair, CPA, uses the cash receipts and disbursements method of reporting. In 1987, a client gave Blair 100 shares of a listed corporation's stock in full satisfaction of a $5,000 accounting fee the client owed Blair. This stock had a fair market value of $4,000 on the date it was given to Blair. The client's basis for this stock was $3,000. Blair sold the stock for cash in January 1988. In Blair's 1987 return, what amount of income should be reported in connection with the receipt of the stock?
   a. $0
   b. $3,000
   c. $4,000
   d. $5,000

2. Smith, a retired corporate executive, earned consulting fees of $8,000 and director's fees of $2,000 in 1987. Smith's gross income from self-employment in 1987 was
   a. $0
   b. $2,000
   c. $8,000
   d. $10,000

3. Pierre, a headwaiter, received tips totaling $2,000 in December 1987. On January 5, 1988, Pierre reported this tip income to his employer in the required written statement. At what amount, and in which year, should this tip income be included in Pierre's gross income?
   a. $2,000 in 1987.
   b. $2,000 in 1988.
   c. $1,000 in 1987, and $1,000 in 1988.
   d. $167 in 1987, and $1,833 in 1988.

4. During 1987, Clark received the following interest income:
   On Veterans Administration insurance dividends left on deposit with the V.A. $20
   On state income tax refund 30
   What amount should Clark include for interest income in his 1987 return?
   a. $50
   b. $30
   c. $20
   d. $0

5. If an individual taxpayer's passive losses and credits relating to rental real estate activities cannot be used in the current year, then they may be carried
   a. Back three years, but they cannot be carried forward.
   b. Forward up to a maximum period of 15 years, but they cannot be carried back.
   c. Back three years or forward up to 15 years, at the taxpayer's election.
   d. Forward indefinitely or until the property is disposed of in a taxable transaction.

6. In 1987, Ben Loy and his wife, Ann, received dividends of $500 and $25, respectively, from taxable domestic corporations. What amount of these dividends could be excluded from the Loys' taxable income on their 1987 joint return?
   a. $0
   b. $125
   c. $200
   d. $225

7. With regard to the alimony deduction in connection with a 1988 divorce, which one of the following statements is correct?
   a. Alimony is deductible by the payor spouse, and includible by the payee spouse, to the extent that payment is contingent on the status of the divorced couple's children.
   b. The divorced couple may be members of the same household at the time alimony is paid, provided that the persons do not live as husband and wife.
   c. Alimony payments must terminate on the death of the payee spouse.
   d. Alimony may be paid either in cash or in property.
8. A 1988 capital loss incurred by a married couple filing a joint return
   a. Will be allowed only to the extent of capital gains.
   b. Will be allowed to the extent of capital gains, plus up to $3,000 of ordinary income.
   c. May be carried forward up to a maximum of five years.
   d. Is not an allowable loss.

9. In 1988, Joan accepted and received a $10,000 award for outstanding civic achievement. Joan was selected without any action on her part, and no future services are expected of her as a condition of receiving the award. What amount should Joan include in her 1988 adjusted gross income in connection with this award?
   a. $0
   b. $4,000
   c. $5,000
   d. $10,000

10. Which one of the following types of allowable deductions can be claimed as a deduction in arriving at an individual's 1988 adjusted gross income?
    a. Unreimbursed business expenses of an outside salesman-employee.
    b. Personal casualty losses.
    c. Charitable contributions.
    d. Alimony payments.

11. Sol and Julia Crane are married, and filed a joint return for 1987. Sol earned a salary of $80,000 in 1987 from his job at Troy Corp., where Sol is covered by his employer's pension plan. In addition, Sol and Julia earned interest of $3,000 in 1987 on their joint savings account. Julia is not employed, and the couple had no other income. On January 15, 1988, Sol contributed $2,000 to an IRA for himself, and $250 to an IRA for his spouse. The allowable IRA deduction in the Cranes' 1987 joint return is
    a. $0
    b. $250
    c. $2,000
    d. $2,250

12. At December 31, 1987, the following assets were among those owned by Rea:

<table>
<thead>
<tr>
<th>Date acquired</th>
<th>Asset</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1986</td>
<td>Personal residence</td>
<td>$200,000</td>
</tr>
<tr>
<td>Feb. 1986</td>
<td>Stock of listed corp.</td>
<td>$16,000</td>
</tr>
<tr>
<td>Dec. 1987</td>
<td>Stock of listed corp.</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

   Total capital assets amounted to
   a. $16,000
   b. $22,000
   c. $216,000
   d. $222,000

13. In 1988, Lyons paid $3,000 to the tax collector of Maple Township for realty taxes on a two-family house owned by Lyons' mother. Of this amount, $1,400 covered back taxes for 1987, and $1,600 was in payment of 1988 taxes. Lyons resides on the second floor of the house, and his mother resides on the first floor. In Lyons' itemized deductions on his 1988 return, what amount may Lyons claim for realty taxes?
    a. $0
    b. $1,500
    c. $1,600
    d. $3,000

14. Which one of the following types of itemized deductions is included in the category of unreimbursed expenses that is deductible only if the aggregate amount of such expenses exceeds 2% of the taxpayer's adjusted gross income?
    a. Employee moving expenses.
    b. Tax return preparation fees.
    c. Medical expenses.
    d. Interest expense.

15. The following information pertains to Cole's personal residence, which sustained casualty fire damage in 1987:

   Adjusted basis $150,000
   Fair market value immediately before the fire 200,000
   Fair market value immediately after the fire 180,000
   Fire damage repairs paid for by Cole in 1987 10,000

   The house was uninsured. Before consideration of any "floor" or other limitation on tax deductibility, the amount of this 1987 casualty loss was
    a. $30,000
    b. $20,000
    c. $10,000
    d. $0

16. Emil Gow's wife died in 1985. Emil did not remarry and he continued to maintain a home for himself and his dependent infant child during 1986 and 1987, providing full support for himself and his child during these years. For 1985, Emil properly filed a joint return. For 1987, Emil's filing status is
    a. Single.
    b. Head of household.
    c. Qualifying widower with dependent child.
    d. Married filing joint return.

17. Raff created a joint bank account for himself and his friend's son, Dave. There is a gift to Dave when
    a. Raff creates the account.
    b. Raff dies.
    c. Dave draws on the account for his own benefit.
    d. Dave is notified by Raff that the account has been created.
18. Proceeds of a life insurance policy payable to the estate’s executor, as the estate’s representative, are
   a. Includible in the decedent’s gross estate only if the premiums had been paid by the insured.
   b. Includible in the decedent’s gross estate only if the policy was taken out within three years of the insured’s death under the “contemplation of death” rule.
   c. Always includible in the decedent’s gross estate.
   d. Never includible in the decedent’s gross estate.

19. Ross, a calendar-year, cash basis taxpayer who died in June 1988, was entitled to receive a $10,000 accounting fee that had not been collected before the date of death. The executor of Ross’ estate collected the full $10,000 in July 1988. This $10,000 should appear in
   a. Only the decedent’s final individual income tax return.
   b. Only the estate’s fiduciary income tax return.
   c. Only the estate tax return.
   d. Both the fiduciary income tax return and the estate tax return.

20. In 1987, Blum, who is single, gave an outright gift of $50,000 to a friend, Gould, who needed the money to pay medical expenses. In filing the 1987 gift tax return, Blum was entitled to a maximum exclusion of
   a. $20,000
   b. $10,000
   c. $3,000
   d. $0

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.

Items to be Answered

21. In 1987, Ryan Corp. had the following income:

   Income from operations $300,000
   Dividends from unrelated taxable domestic corporations 2,000

Ryan had no portfolio indebtedness. In Ryan’s 1987 taxable income, what amount should be included for the dividends received?
   a. $300
   b. $400
   c. $1,600
   d. $1,700

22. The following information pertains to treasury stock sold by Lee Corp. to an unrelated broker in 1987:

   Proceeds received $50,000
   Cost 30,000
   Par value 9,000

What amount of capital gain should Lee recognize in 1987 on the sale of this treasury stock?
   a. $0
   b. $8,000
   c. $20,000
   d. $30,500

23. A corporation’s tax preference items that must be taken into account for 1988 alternative minimum tax purposes include
   b. Casualty losses.
   c. Accelerated depreciation on pre-1987 real property to the extent of the excess over straight-line depreciation.
   d. Capital gains.

24. In 1988, Kara Corp. incurred the following expenditures in connection with the repurchase of its stock from shareholders to avert a hostile takeover:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on borrowings used to repurchase stock</td>
<td>$100,000</td>
</tr>
<tr>
<td>Legal and accounting fees in connection with the repurchase</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

The total of the above expenditures deductible in 1988 is
   a. $0
   b. $100,000
   c. $400,000
   d. $500,000

25. An S corporation’s accumulated adjustments account, which measures the amount of earnings that may be distributed tax-free,
   a. Must be adjusted downward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
   b. Must be adjusted upward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
   c. Must be adjusted upward or downward for only the federal income taxes affected by capital gains or losses, respectively, for any taxable year in which the corporation was a C corporation.
   d. Is not adjusted for federal income taxes attributable to a taxable year in which the corporation was a C corporation.
Items 26 and 27 are based on the following:

Gero Corp. had operating income of $160,000, after deducting $10,000 for contributions to State University, but not including dividends of $2,000 received from nonaffiliated taxable domestic corporations.

26. In computing the maximum allowable deduction for contributions, Gero should apply the percentage limitation to a base amount of
   a. $172,000
   b. $170,400
   c. $170,000
   d. $162,000

27. In applying the percentage limitation to the base amount, in order to compute the maximum allowable deduction for contributions, Gero should use
   a. 50%
   b. 30%
   c. 10%
   d. 5%

28. Dana Corp. owns stock in Seco Corp. For Dana and Seco to qualify for the filing of consolidated returns, at least what percentage of Seco’s total voting power and total value of stock must be directly owned by Dana?

<table>
<thead>
<tr>
<th>Total voting power</th>
<th>Total value of stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 51%</td>
<td>51%</td>
</tr>
<tr>
<td>b. 51%</td>
<td>80%</td>
</tr>
<tr>
<td>c. 80%</td>
<td>51%</td>
</tr>
<tr>
<td>d. 80%</td>
<td>80%</td>
</tr>
</tbody>
</table>

29. Benson, a singer, owns 100% of the outstanding capital stock of Lund Corp. Lund contracted with Benson, specifying that Benson was to perform personal services for Magda Productions, Inc., in consideration of which Benson was to receive $50,000 a year from Lund. Lund contracted with Magda, specifying that Benson was to perform personal services for Magda, in consideration of which Magda was to pay Lund $1,000,000 a year. Personal holding company income will be attributable to
   a. Benson only.
   b. Lund only.
   c. Magda only.
   d. All three contracting parties.

30. The accumulated earnings tax can be imposed
   a. On both partnerships and corporations.
   b. On companies that make distributions in excess of accumulated earnings.
   c. On personal holding companies.
   d. Regardless of the number of stockholders of a corporation.

31. The following information pertains to Rail Corp.:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated earnings and profits</td>
<td>$30,000</td>
</tr>
<tr>
<td>at January 1, 1987</td>
<td></td>
</tr>
<tr>
<td>Earnings and profits for the year ended December 31, 1987</td>
<td>$40,000</td>
</tr>
<tr>
<td>Cash distributions to individual stockholders in 1987</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

   What is the total amount of distributions taxable as dividend income to Rail’s stockholders in 1987?
   a. $0
   b. $40,000
   c. $70,000
   d. $90,000

32. Which one of the following is a corporate reorganization as defined in the Internal Revenue Code?
   a. Mere change in place of organization of one corporation.
   b. Stock redemption.
   c. Change in depreciation method from accelerated to straight-line.
   d. Change in inventory costing method from FIFO to LIFO.

33. For the collapsible corporation provisions to be imposed, the holding period of the corporation’s stock
   a. Must be a minimum of six months.
   b. Must be a minimum of 12 months.
   c. Depends on the stockholder’s basis for gain or loss.
   d. Is irrelevant.

34. The following information pertains to land contributed by Pink for a 50% interest in a new partnership:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted basis to Pink</td>
<td>$100,000</td>
</tr>
<tr>
<td>Fair market value</td>
<td>$300,000</td>
</tr>
<tr>
<td>Mortgage assumed by partnership</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

   The basis for Pink’s partnership interest is
   a. $70,000
   b. $85,000
   c. $100,000
   d. $300,000

35. On July 1, 1987, in exchange for past services rendered, Eng received a 5% interest in the capital of State Associates, a partnership. State’s net assets at July 1, 1987, had a basis of $200,000 and a fair market value of $300,000.

   What amount of ordinary income should Eng include in his 1987 return for the partnership interest transferred to him by the other partners?
   a. $5,000
   b. $7,500
   c. $10,000
   d. $15,000
36. The holding period of property acquired by a partnership as a contribution to the contributing partner’s capital account
   a. Begins with the date of contribution to the partnership.
   b. Includes the period during which the property was held by the contributing partner.
   c. Is equal to the contributing partner’s holding period prior to contribution to the partnership.
   d. Depends on the character of the property transferred.

37. In the computation of the ordinary income of a partnership, a deduction is allowed for
   a. Contributions to qualified charities.
   b. The net operating loss deduction.
   c. Guaranteed payments to partners.
   d. Short-term and long-term capital losses.

38. Carita Fund, organized and operated exclusively for charitable purposes, provides insurance coverage, at amounts substantially below cost, to exempt organizations involved in the prevention of cruelty to children. Carita’s insurance activities are
   a. Exempt from tax.
   b. Treated as unrelated business income.
   c. Subject to the same tax provisions as those applicable to insurance companies.
   d. Considered “commercial-type” as defined by the Internal Revenue Code.

39. Annual information returns of exempt organizations must be filed by
   a. Churches.
   b. Internally supported auxiliaries of churches.
   c. Private foundations.
   d. All exempt organizations whose gross receipts in each taxable year are less than $5,000.

40. The filing of a return covering unrelated business income
   a. Is required of all exempt organizations having at least $1,000 of unrelated business taxable income for the year.
   b. Relieves the organization of having to file a separate annual information return.
   c. Is not necessary if all of the organization’s income is used exclusively for charitable purposes.
   d. Must be accompanied by a minimum payment of 50% of the tax due as shown on the return, with the balance of tax payable six months later.

36. The holding period of property acquired by a partnership as a contribution to the contributing partner’s capital account.

37. In the computation of the ordinary income of a partnership, a deduction is allowed for contributions to qualified charities.

40. The filing of a return covering unrelated business income is required of all exempt organizations having at least $1,000 of unrelated business taxable income for the year.
44. The following proceeds received by Grove City in 1987 are legally restricted to expenditure for specified purposes:

Donation by a benefactor mandated to an expendable trust fund to provide meals for the needy $300,000
Sales taxes to finance the maintenance of tourist facilities in the shopping district 900,000

What amount should be accounted for in Grove's special revenue funds?

a. $0  
   b. $300,000  
   c. $900,000  
   d. $1,200,000

45. In connection with Albury Township's long-term debt, the following cash accumulations are available to cover payment of principal and interest on

Bonds for financing of water treatment plant construction $1,000,000
General long-term obligations 400,000

The amount of these cash accumulations that should be accounted for in Albury's debt service funds is

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

46. During its fiscal year ended June 30, 1988, Lake County financed the following projects by special assessments:

   Capital improvements $2,000,000
   Service-type projects 800,000

For financial reporting purposes, what amount should appear in special assessment funds?

a. $2,800,000  
   b. $2,000,000  
   c. $800,000  
   d. $0

47. Hull City has established a separate internal service (self-insurance) fund to pay claims and judgments of all of Hull's funds. In 1987, payments to the insurer fund amounted to $500,000, while the actuarially determined amount was $400,000. The payments to the insurer fund should be accounted for as

\[
\begin{array}{cc}
\text{An operating transfer of} & \text{A residual equity transfer of} \\
$0 & $0 \\
$100,000 & $400,000 \\
$400,000 & $100,000 \\
$500,000 & $0 \\
\end{array}
\]

48. The following fund types used by cliff City had total assets at December 31, 1987 as follows:

- Special revenue funds $100,000
- Agency funds 150,000
- Trust funds 200,000

Total fiduciary fund assets amounted to

a. $200,000  
   b. $300,000  
   c. $350,000  
   d. $450,000

49. The following information pertains to a computer that Pine Township leased from Karl Supply Co. on July 1, 1988, for general township use:

Karl's cost $5,000
Fair value at July 1, 1988 $5,000
Estimated economic life 5 years
Fixed noncancelable term 30 months
Rental at beginning of each month $135
Guaranteed residual value $2,000
Present value of minimum lease payments at July 1, 1988, using Karl's incremental borrowing rate of 10.5% $5,120
Karl's implicit interest rate of 12.04% $5,000

On July 1, 1988, what amount should Pine capitalize in its general fixed assets account group for this leased computer?

a. $0  
   b. $3,000  
   c. $5,000  
   d. $5,120

50. Ridge City issued the following bonds during the year ended July 31, 1988:

General obligation bonds issued for the Ridge water and sewer enterprise fund that will service the debt $700,000
Revenue bonds to be repaid from admission fees collected by the Ridge municipal swimming pool enterprise fund 290,000

The amount of these bonds that should be accounted for in Ridge's general long-term debt account group is

a. $590,000  
   b. $700,000  
   c. $290,000  
   d. $0
Accounting Practice — Part II

51. Lane Foundation received a nonexpendable endowment of $500,000 in 1986 from Gant Enterprises. The endowment assets were invested in publicly traded securities. Gant did not specify how gains and losses from dispositions of endowment assets were to be treated. No restrictions were placed on the use of dividends received and interest earned on fund resources. In 1987, Lane realized gains of $50,000 on sales of fund investments, and received total interest and dividends of $40,000 on fund securities. The amount of these capital gains, interest, and dividends available for expenditure by Lane’s unrestricted current fund is
   a. $0
   b. $40,000
   c. $50,000
   d. $90,000

52. In 1987, the Board of Trustees of Burr Foundation designated $100,000 from its current funds for college scholarships. Also in 1987, the foundation received a bequest of $200,000 from an estate of a benefactor who specified that the bequest was to be used for hiring teachers to tutor handicapped students. What amount should be accounted for as current restricted funds?
   a. $0
   b. $100,000
   c. $200,000
   d. $300,000

53. The following information pertains to interest received by Beech University from endowment fund investments for the year ended June 30, 1988:

<table>
<thead>
<tr>
<th></th>
<th>Received</th>
<th>Expended forcurrent operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrestricted</td>
<td>$300,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Restricted</td>
<td>500,000</td>
<td>75,000</td>
</tr>
</tbody>
</table>

What amount should be credited to endowment income for the year ended June 30, 1988?
   a. $800,000
   b. $375,000
   c. $175,000
   d. $100,000

54. On July 31, 1988, Sabio College showed the following amounts to be used for

- Renewal and replacement of college properties $200,000
- Retirement of indebtedness on college properties 300,000
- Purchase of physical properties for college purposes, but unexpended at 7/31/88 400,000

What total amount should be included in Sabio’s plant funds at July 31, 1988?
   a. $900,000
   b. $600,000
   c. $400,000
   d. $200,000

55. For the 1987 fall semester, Brook University assessed its students $4,000,000 (net of refunds), covering tuition and fees for educational and general purposes. However, only $3,700,000 was expected to be realized because tuition remissions of $80,000 were allowed to faculty members’ children attending Brook and scholarships totaling $220,000 were granted to students. What amount should Brook include in educational and general current funds revenues from student tuition and fees?
   a. $4,000,000
   b. $3,920,000
   c. $3,780,000
   d. $3,700,000

56. Under Cura Hospital’s established rate structure, patient service revenues of $9,000,000 would have been earned for the year ended December 31, 1987. However, only $6,750,000 was collected because of charity allowances of $1,500,000 and discounts of $750,000 to third-party payors. For the year ended December 31, 1987, what amount should Cura record as patient service revenues?
   a. $6,750,000
   b. $7,500,000
   c. $8,250,000
   d. $9,000,000

57. An organization of high school seniors performs services for patients at Leer Hospital. These students are volunteers and perform services that the hospital would not otherwise provide, such as wheeling patients in the park and reading to patients. Leer has no employer-employee relationship with these volunteers, who donated 5,000 hours of service to Leer in 1987. At the minimum wage rate, these services would amount to $18,750, while it is estimated that the fair value of these services was $25,000. In Leer’s 1987 statement of revenues and expenses, what amount should be reported as nonoperating revenue?
   a. $25,000
   b. $18,750
   c. $6,250
   d. $0

58. In June 1988, Park Hospital purchased medicines from Jove Pharmaceutical Co. at a cost of $2,000. However, Jove notified Park that the invoice was being canceled, and that the medicines were being donated to Park. Park should record this donation of medicines as
   a. A memorandum entry only.
   b. Other operating revenue of $2,000.
   c. A $2,000 credit to operating expenses.
   d. A $2,000 credit to nonoperating expenses.
59. In 1987, a nonprofit trade association enrolled five new member companies, each of which was obligated to pay nonrefundable initiation fees of $1,000. These fees were receivable by the association in 1987. Three of the new members paid the initiation fees in 1987, and the other two new members paid their initiation fees in 1988. Annual dues (excluding initiation fees) received by the association from all of its members have always covered the organization’s costs of services provided to its members. It can be reasonably expected that future dues will cover all costs of the organization’s future services to members. Average membership duration is 10 years because of mergers, attrition, and economic factors. What amount of initiation fees from these five new members should the association recognize as revenue in 1987?
   a. $5,000
   b. $3,000
   c. $500
   d. $0

60. On January 2, 1987, a nonprofit botanical society received a gift of an exhaustible fixed asset with an estimated useful life of 10 years and no salvage value. The donor’s cost of this asset was $20,000, and its fair market value at the date of the gift was $30,000. What amount of depreciation of this asset should the society recognize in its 1987 financial statements?
   a. $3,000
   b. $2,500
   c. $2,000
   d. $0

Examination Questions — November 1988

Number 4 (Estimated time — 45 to 55 minutes)

Lino Corporation’s liability account balances at December 31, 1986 included the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable to bank</td>
<td>$800,000</td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>280,000</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Additional information:

- The note payable, dated October 1, 1986, bears interest at an annual rate of 10% payable semiannually on April 1 and October 1. Principal payments are due annually on October 1 in four equal installments.
- The capital lease is for a 10-year period beginning December 31, 1981. Equal annual payments of $100,000 are due on December 31 of each year. The 16% interest rate implicit in the lease is known by Lino. At December 31, 1986, the present value of the four remaining lease payments discounted at 16% was $280,000.
- Deferred income taxes are provided in recognition of timing differences between financial statement and income tax reporting of depreciation. For the year ended December 31, 1987, depreciation per tax return exceeded book depreciation by $50,000. Lino’s income tax rate for 1987 was 30%.
- On July 1, 1987, Lino issued $1,000,000 face amount of 10-year, 10% bonds for $750,000, to yield 15%. Interest is payable annually on July 1. Bond discount is amortized by the interest method.
- All required principal and interest payments were made on schedule in 1987.

Required:

b. Prepare a schedule showing interest expense that should appear in Lino’s income statement for the year ended December 31, 1987.
Accounting Practice — Part II

Number 5 (Estimated time — 40 to 50 minutes)

Amar Supermarkets Corp., operates a chain of three retail stores in a state that permits municipalities to levy an income tax on businesses operating within their respective boundaries. The tax rate is uniform in all of the municipalities that levy the tax, and does not vary according to taxable income. Regulations provide that the tax is to be computed on income earned within the particular taxing municipality, after reasonable and consistent allocation of the corporation’s overhead. Amar’s overhead consists of expenses pertaining to the warehouse, central office, advertising, and delivery.

For the year ended December 31, 1987, operating results for each store, before taxes and allocation of corporation overhead, were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Birch</th>
<th>Maple</th>
<th>Spruce</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$500,000</td>
<td>$400,000</td>
<td>$300,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>280,000</td>
<td>230,000</td>
<td>190,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>220,000</td>
<td>170,000</td>
<td>110,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Local operating expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed</td>
<td>70,000</td>
<td>60,000</td>
<td>50,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Variable</td>
<td>66,000</td>
<td>73,000</td>
<td>31,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Totals</td>
<td>136,000</td>
<td>133,000</td>
<td>81,000</td>
<td>350,000</td>
</tr>
<tr>
<td>Income before corporation overhead and taxes</td>
<td>$84,000</td>
<td>$37,000</td>
<td>$29,000</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

For the year ended December 31, 1987, corporation overhead was as follows:

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Warehouse and delivery</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Warehouse depreciation</td>
<td>$10,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Warehouse operations</td>
<td></td>
<td>$15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Delivery</td>
<td></td>
<td></td>
<td>$35,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Central office</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>$8,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td></td>
<td>$30,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>2,000</td>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td>Total corporation overhead</td>
<td></td>
<td></td>
<td></td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Delivery expenses vary with distances from the warehouse and numbers of deliveries to stores. Delivery statistics for 1987 are as follows:

<table>
<thead>
<tr>
<th>Store</th>
<th>Miles from warehouse</th>
<th>Number of deliveries</th>
<th>Delivery miles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Birch</td>
<td>100</td>
<td>150</td>
<td>15,000</td>
</tr>
<tr>
<td>Maple</td>
<td>200</td>
<td>50</td>
<td>10,000</td>
</tr>
<tr>
<td>Spruce</td>
<td>25</td>
<td>200</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Management has engaged a CPA firm to evaluate two corporation overhead allocation plans that are being considered, so that operating results under both plans can be compared. In addition, management has decided to expand one of the stores in a plan to increase sales by $80,000. The contemplated expansion is expected to increase local fixed operating costs by $8,000 and to require 10 additional deliveries from the warehouse. The CPA firm has been requested to furnish management with a recommendation as to which store should be selected for the prospective expansion.
Number 5 (continued)

Required:

a. Rounding off to the nearest whole percent, compute each store's income that would be subject to the municipal income tax under the following two plans:

   Plan 1. Allocate all corporation overhead on the basis of sales.
   Plan 2. Allocate central office salaries and other central office overhead equally to warehouse operations and to each store. Then, allocate the resulting warehouse operations costs, warehouse depreciation, and advertising to each store on the basis of sales. Finally, allocate delivery expenses to each store on the basis of delivery miles.

b. Compute each store's increase in relevant expenses, including delivery expenses, but before allocation of other corporation overhead and taxes as a result of the contemplated expansion. Determine which of the three stores should be selected for expansion to maximize corporate net income.
EXAMINATION IN AUDITING

November 3, 1988; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<table>
<thead>
<tr>
<th>All questions are required:</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>Total</td>
<td>100</td>
<td>150 210</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.

N-25
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 c d

Items to be Answered

1. An accountant who is not independent of a client is precluded from issuing a
   a. Compilation report on historical financial statements.
   b. Compilation report on prospective financial statements.
   c. Special report on compliance with contractual agreements.
   d. Report on management advisory services.

2. Which of the following elements underlies the application of generally accepted auditing standards, particularly the standards of field work and reporting?
   a. Internal accounting control.
   b. Corroborating evidence.
   c. Quality control.
   d. Materiality and relative risk.

3. Which of the following acts by a CPA who is not in public practice would most likely be considered a violation of the ethical standards of the profession?
   a. Using the CPA designation without disclosing employment status in connection with financial statements issued for external use by the CPA’s employer.
   b. Distributing business cards indicating the CPA designation and the CPA’s title and employer.
   c. Corresponding on the CPA’s employer’s letterhead, which contains the CPA designation and the CPA’s employment status.
   d. Compiling the CPA’s employer’s financial statements and making reference to the CPA’s lack of independence.

4. The ethical standards of the profession would most likely be considered to be violated if a CPA
   a. Owns a building and leases a portion of the space to an audit client.
   b. Has an insured account with a brokerage firm that is an audit client and the account is used for occasional cash transactions.
   c. Is asked by an audit client to act as a “finder” in the acquisition of another company on a per diem basis.
   d. Searches for and initially screens candidates for the vacant controllership of an audit client.

5. Which of the following statements best explains why the CPA profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance?
   a. Vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts.
   b. Ethical standards that emphasize excellence in performance over material rewards establish a reputation for competence and character.
   c. A distinguishing mark of a profession is its acceptance of responsibility to the public.
   d. A requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues.

6. Which of the following procedures would an auditor most likely include in the initial planning of an examination of financial statements?
   a. Discussing the examination with firm personnel responsible for non-audit services to the client.
   b. Inquiring of the client’s attorney as to any claims probable of assertion.
   c. Obtaining a written representation letter from management of the client.
   d. Determining whether necessary internal accounting control procedures are being applied as prescribed.

7. The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the
   a. Audit procedures performed are approved in the professional standards.
   b. Examination has been performed by persons having adequate technical training and proficiency as auditors.
   c. Auditor’s system of quality control has been maintained at a high level.
   d. Results are consistent with the conclusions to be presented in the auditor’s report.
Auditing

8. Which of the following procedures would an auditor ordinarily perform during the review of subsequent events?
   a. An analysis of related party transactions for the discovery of possible irregularities.
   b. A review of the cut-off bank statements for the period after the year-end.
   c. An inquiry of the client's legal counsel concerning litigation.
   d. An investigation of material weaknesses in internal accounting control previously communicated to the client.

9. Which of the following circumstances would most likely cause an auditor to suspect that material irregularities exist in a client's financial statements?
   a. Property and equipment are usually sold at a loss before being fully depreciated.
   b. Significantly fewer responses to confirmation requests are received than expected.
   c. Monthly bank reconciliations usually include several in-transit items.
   d. Clerical errors are listed on an EDP-generated exception report.

10. An auditor's tests of the pricing of a client's inventory indicates the existence of many errors. However, because of inadequate records the auditor is uncertain about whether these errors materially affect the financial statements taken as a whole. The auditor may reasonably issue a (an) "Subject to" qualified opinion.

<table>
<thead>
<tr>
<th>Subject to qualified opinion</th>
<th>Adverse opinion</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>

11. A CPA firm should establish procedures for conducting and supervising work at all organizational levels to provide reasonable assurance that the work performed meets the firm's standards of quality. To achieve this goal, the firm most likely would establish procedures for:
   a. Evaluating prospective and continuing client relationships.
   b. Reviewing engagement working papers and reports.
   c. Requiring personnel to adhere to the applicable independence rules.
   d. Maintaining personnel files containing documentation related to the evaluation of personnel.

12. An auditor of a manufacturer would most likely question whether that client has committed illegal acts if the client has:
   a. Been forced to discontinue operations in a foreign country.
   b. Been an annual donor to a local political candidate.
   c. Failed to correct material weaknesses in internal accounting control that were reported after the prior year's audit.
   d. Disclosed several subsequent events involving foreign operations in the notes to the financial statements.

13. The purpose of compliance tests is to provide reasonable assurance that:
   a. Internal accounting control procedures are being applied as prescribed.
   b. The extent of substantive testing is kept to a minimum.
   c. Errors and irregularities are prevented or detected in a timely manner.
   d. The auditor has an understanding of the control environment.

14. The Securities and Exchange Commission has authority to:
   a. Prescribe specific auditing procedures to detect fraud concerning inventories and accounts receivable of companies engaged in interstate commerce.
   b. Deny lack of privity as a defense in third-party actions for gross negligence against the auditors of public companies.
   c. Determine accounting principles for the purpose of financial reporting by companies offering securities to the public.
   d. Require a change of auditors of governmental entities after a given period of years as a means of ensuring auditor independence.

15. Which of the following standards applies to management advisory services engagements?
   a. In all matters relating to the assignment, an independence in mental attitude is to be maintained.
   b. There is to be a proper study and evaluation of the existing internal accounting control as a basis for reliance thereon.
   c. The work is to be adequately planned and assistants are to be properly supervised.
   d. Informative disclosures are to be regarded as reasonably adequate unless otherwise stated in the report.
16. An auditor’s report includes the following statement: “The financial statements do not present fairly the financial position, results of operations, or cash flows in conformity with generally accepted accounting principles.” This auditor’s report was most likely issued in connection with financial statements that are
a. Inconsistent.
b. Based on prospective financial information.
c. Misleading.
d. Affected by a material uncertainty.

17. An auditor includes a middle paragraph in an otherwise unqualified report to emphasize that the financial statements are not comparable to those of prior years due to a court-ordered divestiture that is already fully explained in the notes to the financial statements. The inclusion of this paragraph
a. Should be followed by an “except for” consistency modification in the opinion paragraph.
b. Requires a revision of the opinion paragraph to include the phrase “with the foregoing explanation.”
c. Is not appropriate and may confuse the readers or lead them to believe the report was qualified.
d. Is appropriate and would not negate the unqualified opinion.

18. Green, CPA, is requested to render an opinion on the application of accounting principles by an entity that is audited by another CPA. Green may
a. Not accept such an engagement because to do so would be considered unethical.
b. Not accept such an engagement because Green would lack the necessary information on which to base an opinion without conducting an audit.
c. Accept the engagement but should form an independent opinion without consulting with the continuing CPA.
d. Accept the engagement but should consult with the continuing CPA to ascertain all the available facts relevant to forming a professional judgment.

19. An auditor may reasonably issue an “except for” qualified opinion for

<table>
<thead>
<tr>
<th>Inadequate disclosure</th>
<th>Scope limitation</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>

20. An auditor may reasonably issue a “subject to” qualified opinion for

<table>
<thead>
<tr>
<th>Lack of consistency</th>
<th>Departure from generally accepted accounting principles</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>

21. An auditor did not examine an entity’s financial statements for the preceding year. Inadequate financial records precluded an opinion as to asset and liability balances at the beginning of the current year and the consistent application of generally accepted accounting principles. The auditor should explain the inadequacies in the financial records in
a. A middle paragraph, the lack of consistency in the opinion paragraph, and express a disclaimer of opinion on the financial statements.
b. A middle paragraph, the lack of consistency also in the middle paragraph, and express an opinion only on the balance sheet.
c. The opinion paragraph, the lack of consistency also in the opinion paragraph, and express a disclaimer of opinion on the financial statements.
d. The opinion paragraph, the lack of consistency also in the opinion paragraph, and express an opinion only on the balance sheet.

22. Each page of a nonpublic entity’s financial statements reviewed by an accountant should include the following reference:
   b. Reviewed, No Accountant’s Assurance Expressed.
   c. See Accompanying Accountant’s Footnotes.
   d. Reviewed, No Material Modifications Required.

23. An auditor’s document includes the following statement:

“Our audit is subject to the risk that errors, irregularities, or illegal acts, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of any such matters that come to our attention.”

The above passage is most likely from
a. The explanatory paragraph of a “subject to” qualified auditor’s report.
b. An engagement letter.
c. The explanatory paragraph of a compliance report on a governmental entity subject to GAO standards.
d. A comfort letter.
24. An accountant may accept an engagement to apply agreed-upon procedures that are not sufficient to express an opinion on one or more specified accounts or items of a financial statement provided that
   a. The accountant's report does not enumerate the procedures performed.
   b. The financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.
   c. Distribution of the accountant's report is restricted.
   d. The accountant is also the entity's continuing auditor.

25. Reports are considered special reports when issued in connection with
   a. Compliance with aspects of regulatory requirements related to audited financial statements.
   b. Pro forma financial presentations designed to demonstrate the effect of hypothetical transactions.
   c. Feasibility studies presented to illustrate an entity's results of operations.
   d. Interim financial information reviewed to determine whether material modifications should be made to conform with generally accepted accounting principles.

26. When an accountant issues to an underwriter a comfort letter containing comments on data that have not been audited, the underwriter most likely will receive
   a. Positive assurance on supplementary disclosures.
   b. Negative assurance on capsule information.
   c. A disclaimer on prospective financial statements.
   d. A limited opinion on "pro forma" financial statements.

27. Prospective financial information presented in the format of historical financial statements that omit either gross profit or net income is deemed to be a
   a. Partial presentation.
   b. Projected balance sheet.
   c. Financial forecast.
   d. Financial projection.

28. After an audit report containing an unqualified opinion on a non-public client's financial statements was issued, the client decided to sell the shares of a subsidiary that accounts for 30% of its revenue and 25% of its net income. The auditor should
   a. Determine whether the information is reliable and, if determined to be reliable, request that revised financial statements be issued.
   b. Notify the entity that the auditor's report may no longer be associated with the financial statements.
   c. Describe the effects of this subsequently discovered information in a communication with persons known to be relying on the financial statements.
   d. Take no action because the auditor has no obligation to make any further inquiries.

29. The principal auditor is satisfied with the independence and professional reputation of the other auditor who has audited the financial statements of a subsidiary. To indicate the division of responsibility, the principal auditor should modify
   a. Only the opinion paragraph of the report.
   b. Only the opinion paragraph of the report and include an explanatory middle paragraph.
   c. Only the scope paragraph of the report.
   d. Both the scope and opinion paragraphs of the report.

30. An accountant should not submit unaudited financial statements to the management of a nonpublic company unless, at a minimum, the accountant
   a. Assists in adjusting the books of account and prepares the trial balance.
   b. Types or reproduces the financial statements on plain paper.
   c. Complies with the standards applicable to compilation engagements.
   d. Applies analytical procedures to the financial statements.

31. In evaluating internal accounting control, the auditor is basically concerned that the system provides reasonable assurance that
   a. Operational efficiency has been achieved in accordance with management plans.
   b. Errors and irregularities have been prevented or detected.
   c. Controls have not been circumvented by collusion.
   d. Management can not override the system.

32. Proper segregation of functional responsibilities in an effective system of internal accounting control calls for separation of the functions of
   a. Authorization, execution, and payment.
   b. Authorization, recording, and custody.
   c. Custody, execution, and reporting.
   d. Authorization, payment, and recording.
33. A basic objective of a CPA firm is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through
   a. Compliance with generally accepted reporting standards.
   b. A system of quality control.
   c. A system of peer review.
   d. Continuing professional education.

34. When performing the review of an internal accounting control system’s design, an auditor may obtain answers to an internal accounting control questionnaire. The next step ordinarily should be to
   a. Make a preliminary evaluation of whether specific control procedures are suitably designed for reliance, assuming satisfactory compliance.
   b. Perform compliance tests to provide reasonable assurance that the control procedures are being applied as prescribed.
   c. Gather enough evidence to determine if the internal accounting control system is effective in preventing or detecting errors and irregularities.
   d. Design substantive tests that do not contemplate reliance on the control procedures that appear to be ineffective.

35. An auditor’s study and evaluation of the internal accounting control system made in connection with an annual audit is usually not sufficient to express an opinion on an entity’s system because
   a. The evaluation of weaknesses is subjective enough that an auditor should not express an opinion on the internal accounting controls alone.
   b. The audit cost-benefit relationship permits an auditor to express only reasonable assurance that the system operates as designed.
   c. Management may change the internal accounting controls to correct weaknesses.
   d. Only those controls on which an auditor intends to rely are reviewed, tested, and evaluated.

36. Which of the following characteristics distinguishes computer processing from manual processing?
   a. Computer processing virtually eliminates the occurrence of computational error normally associated with manual processing.
   b. Errors or irregularities in computer processing will be detected soon after their occurrences.
   c. The potential for systematic error is ordinarily greater in manual processing than in computerized processing.
   d. Most computer systems are designed so that transaction trails useful for audit purposes do not exist.

37. After an auditor prepared a flowchart of the internal accounting controls relating to sales and evaluated the design of the system, the auditor would perform compliance tests on all internal accounting control procedures
   a. That would aid in preventing irregularities.
   b. Documented in the flowchart.
   c. Considered to be weaknesses that might allow errors to enter the accounting system.
   d. Considered to be strengths that the auditor plans to rely on.

38. Which of the following would most likely be a weakness in the internal accounting control system of a client that utilizes microcomputers rather than a larger computer system?
   a. Employee collusion possibilities are increased because microcomputers from one vendor can process the programs of a system from a different vendor.
   b. The microcomputer operators may be able to remove hardware and software components and modify them at home.
   c. Programming errors result in all similar transactions being processed incorrectly when those transactions are processed under the same conditions.
   d. Certain transactions may be automatically initiated by the microcomputers and management’s authorization of these transactions may be implicit in its acceptance of the system design.

39. During the review of a small business client’s internal accounting control system, the auditor discovered that the accounts receivable clerk approves credit memos and has access to cash. Which of the following controls would be most effective in offsetting this weakness?
   a. The owner reviews errors in billings to customers and postings to the subsidiary ledger.
   b. The controller receives the monthly bank statement directly and reconciles the checking accounts.
   c. The owner reviews credit memos after they are recorded.
   d. The controller reconciles the total of the detail accounts receivable accounts to the amount shown in the ledger.

40. At which point in an ordinary sales transaction of a wholesaling business would a lack of specific authorization least concern the auditor conducting an audit?
   a. Determining discounts.
   b. Selling goods for cash.
   c. Granting credit.
   d. Shipping goods.
Auditing

41. Cash receipts from sales on account have been misappropriated. Which of the following acts would conceal this defalcation and be least likely to be detected by an auditor?
   a. Understating the sales journal.
   b. Overstating the accounts receivable control account.
   c. Overstating the accounts receivable subsidiary ledger.
   d. Understating the cash receipts journal.

42. For effective internal accounting control, the accounts payable department should compare the information on each vendor’s invoice with the
   a. Receiving report and the purchase order.
   b. Receiving report and the voucher.
   c. Vendor’s packing slip and the purchase order.
   d. Vendor’s packing slip and the voucher.

43. Which of the following is the most effective control procedure to detect vouchers that were prepared for the payment of goods that were not received?
   a. Count goods upon receipt in storeroom.
   b. Match purchase order, receiving report, and vendor’s invoice for each voucher in accounts payable department.
   c. Compare goods received with goods requisitioned in receiving department.
   d. Verify vouchers for accuracy and approval in internal audit department.

44. Which of the following control procedures would most likely be used to maintain accurate perpetual inventory records?
   a. Independent storeroom count of goods received.
   b. Periodic independent reconciliation of control and subsidiary records.
   c. Periodic independent comparison of records with goods on hand.
   d. Independent matching of purchase orders, receiving reports, and vendors’ invoices.

45. If a control total were to be computed on each of the following data items, which would best be identified as a hash total for a payroll EDP application?
   a. Hours worked.
   b. Total debits and total credits.
   c. Net pay.
   d. Department numbers.

46. Which of the following procedures is most likely to prevent the improper disposition of equipment?
   a. A separation of duties between those authorized to dispose of equipment and those authorized to approve removal work orders.
   b. The use of serial numbers to identify equipment that could be sold.
   c. Periodic comparison of removal work orders to authorizing documentation.
   d. A periodic analysis of the scrap sales and the repairs and maintenance accounts.

47. Which of the following statements is correct concerning the auditor’s required communication of a material weakness in internal accounting control?
   a. A weakness that management refuses to correct should be included in a separate paragraph of the auditor’s report.
   b. A weakness previously communicated during the prior year’s audit that has not been corrected should be communicated again in writing.
   c. Suggested corrective action for management’s consideration concerning a weakness need not be communicated to the client.
   d. The auditor should test for compliance any weakness discovered before communicating it to the client.

48. A CPA has performed an examination of the general purpose financial statements of Big City. The examination scope included the additional requirements of the Single Audit Act. When reporting on Big City’s internal accounting and administrative controls used in administering a federal financial assistance program, the CPA should
   a. Communicate those weaknesses that are material in relation to the general purpose financial statements.
   b. Express an opinion on the systems used to administer major federal financial assistance programs and express negative assurance on the systems used to administer nonmajor federal financial assistance programs.
   c. Communicate those weaknesses that are material in relation to the federal financial assistance program.
   d. Express negative assurance on the systems used to administer major federal financial assistance programs and express no opinion on the systems used to administer nonmajor federal financial assistance programs.

49. Which of the following conclusions could an auditor most likely make on completing the preliminary phase of the review of internal accounting control?
   a. Specific control procedures are suitably designed for the auditor to rely on to restrict the extent of substantive tests, assuming satisfactory compliance.
   b. The audit effort required to study and evaluate the design of the system exceeds the reduction in audit effort that could be achieved by reliance on the system.
   c. The accounting control procedures are suitably designed to provide reasonable assurance that errors and irregularities will be prevented or detected, provided functions are properly segregated.
   d. Compliance tests indicate that access to computer operations is so unrestricted that the internal accounting control system cannot be relied on to restrict the extent of substantive tests.
50. During a compilation of a nonpublic entity's financial statements, an accountant would be least likely to:
   a. Omit substantially all of the disclosures required by generally accepted accounting principles.
   b. Issue a compilation report on one or more, but not all of the basic financial statements.
   c. Perform analytical procedures designed to identify relationships that appear to be unusual.
   d. Read the compiled financial statements and consider whether they appear to include adequate disclosure.

51. A basic premise underlying analytical review procedures is that:
   a. These procedures can not replace tests of balances and transactions.
   b. Statistical tests of financial information may lead to the discovery of material errors in the financial statements.
   c. The study of financial ratios is an acceptable alternative to the investigation of unusual fluctuations.
   d. Relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.

52. An auditor who uses the work of a specialist may refer to and identify the specialist in the auditor's report if the:
   a. Specialist is also considered to be a related party.
   b. Auditor indicates a division of responsibility related to the work of the specialist.
   c. Specialist's work provides the auditor greater assurance of reliability.
   d. Auditor expresses an "except for" qualified opinion or an adverse opinion related to the work of the specialist.

53. An auditor should obtain evidential matter relevant to all the following factors concerning third-party litigation against a client except the:
   a. Period in which the underlying cause for legal action occurred.
   b. Probability of an unfavorable outcome.
   c. Jurisdiction in which the matter will be resolved.
   d. Existence of a situation indicating an uncertainty as to the possible loss.

54. An auditor analyzes repairs and maintenance accounts primarily to obtain evidence in support of the audit assertion that all:
   a. Noncapitalizable expenditures for repairs and maintenance have been properly charged to expense.
   b. Expenditures for property and equipment have not been charged to expense.
   c. Noncapitalizable expenditures for repairs and maintenance have been recorded in the proper period.
   d. Expenditures for property and equipment have been recorded in the proper period.

55. For which of the following account balances are substantive tests of details least likely to be performed unless analytical review procedures indicate the need to extend detail testing?
   a. Payroll expense.
   b. Marketable securities.
   c. Research and development costs.
   d. Legal expense.

56. Which of the following statements concerning working papers is incorrect?
   a. An auditor may support an opinion by other means in addition to working papers.
   b. The form of working papers should be designed to meet the circumstances of a particular engagement.
   c. An auditor's working papers may not serve as a reference source for the client.
   d. Working papers should show that the internal accounting control system has been studied and evaluated to the degree necessary.

57. The two requirements crucial to achieving audit efficiency and effectiveness with a microcomputer are selecting:
   a. The appropriate audit tasks for microcomputer applications and the appropriate software to perform the selected audit tasks.
   b. The appropriate software to perform the selected audit tasks and client data that can be accessed by the auditor's microcomputer.
   c. Client data that can be accessed by the auditor's microcomputer and audit procedures that are generally applicable to several clients in a specific industry.
   d. Audit procedures that are generally applicable to several clients in a specific industry and the appropriate audit tasks for microcomputer applications.

58. Compiled financial statements should be accompanied by a report stating all the following except:
   a. The accountant does not express an opinion or any other form of assurance on the financial statements.
   b. A compilation is substantially less in scope than an examination in accordance with generally accepted auditing standards.
   c. The accountant compiled the financial statements in accordance with standards established by the AICPA.
   d. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
Item 59 is based on the following flowchart:

The above flowchart depicts
a. Program code checking.
b. Parallel simulation.
c. Integrated test facility.
d. Controlled reprocessing.

Item 60 is based on the following flowchart:

In a credit sales and cash receipts system flowchart symbol X could represent
a. Auditor's test data.
b. Remittance advices.
c. Error reports.
d. Credit authorization forms.
Number 2 (Estimated time — 15 to 25 minutes)

Temple, CPA, is auditing the financial statements of Ford Lumber Yards, Inc., a privately-held corporation with 300 employees and five stockholders, three of whom are active in management. Ford has been in business for many years, but has never had its financial statements audited. Temple suspects that the substance of some of Ford’s business transactions differ from their form because of the pervasiveness of related party relationships and transactions in the local building supplies industry.

Required:
Describe the audit procedures Temple should apply to identify related party relationships and transactions.

Number 3 (Estimated time — 15 to 25 minutes)

Sampling for attributes is often used to allow an auditor to reach a conclusion concerning a rate of occurrence in a population. A common use in auditing is to test the rate of deviation from a prescribed internal accounting control procedure to determine whether planned reliance on that control is appropriate.

Required:

a. When an auditor samples for attributes, identify the factors that should influence the auditor’s judgment concerning the determination of
   1. Acceptable level of risk of overreliance,
   2. Tolerable deviation rate, and
   3. Expected population deviation rate.

b. State the effect on sample size of an increase in each of the following factors, assuming all other factors are held constant:
   1. Acceptable level of risk of overreliance,
   2. Tolerable deviation rate, and
   3. Expected population deviation rate.

c. Evaluate the sample results of a test for attributes if authorizations are found to be missing on 7 check requests out of a sample of 100 tested. The population consists of 2500 check requests, the tolerable deviation rate is 8%, and the acceptable level of risk of overreliance is low.

d. How may the use of statistical sampling assist the auditor in evaluating the sample results described in c, above?
Auditing

Number 4 (Estimated time — 15 to 25 minutes)

The following report on the basic financial statements was drafted by a staff assistant at the completion of the review engagement of GLM Company, a continuing client, for the year ended September 30, 1988. The 1987 basic financial statements for the year ended September 30, 1987, which were also reviewed, contained a departure from generally accepted accounting principles that was properly referred to in the 1987 review report dated October 26, 1987. The 1987 financial statements have been restated.

To the Board of Directors of GLM Company:

We have reviewed the accompanying balance sheets of GLM Company as of September 30, 1988 and 1987, and the related statements of income and retained earnings for the years then ended, in accordance with generally accepted auditing standards. Our review included such tests of the accounting records as we considered necessary in the circumstances.

A review consists principally of inquiries of company personnel. It is substantially less in scope than an audit, but more in scope than a compilation. Accordingly, we express only limited assurance on the accompanying financial statements.

Based on our reviews, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles applied on a consistent basis.

In its 1987 financial statements the company stated its land at appraised values. However, as disclosed in note X, the company has restated its 1987 financial statements to reflect land at cost.

November 2, 1988

Required:

Identify the deficiencies in the draft of the proposed report on the comparative financial statements. Group the deficiencies by paragraph. Do not redraft the report.

Number 5 (Estimated time — 15 to 25 minutes)

The purpose of all auditing procedures is to gather sufficient competent evidence for an auditor to form an opinion regarding the financial statements taken as a whole.

Required:

a. In addition to the example below, identify and describe five means or techniques of gathering audit evidence used to evaluate a client’s inventory balance.

<table>
<thead>
<tr>
<th>Technique</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Observation</td>
<td>An auditor watches the performance of some function, such as a client’s annual inventory count.</td>
</tr>
</tbody>
</table>

b. Identify the five general assertions regarding a client’s inventory balance and describe one different substantive auditing procedure for each assertion. Use the format illustrated below.

<table>
<thead>
<tr>
<th>Assertion</th>
<th>Substantive Auditing Procedure</th>
</tr>
</thead>
</table>

N-35
EXAMINATION IN BUSINESS LAW

(Commercial Law)

November 4, 1988; 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>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>60</td>
<td>110</td>
<td>130</td>
</tr>
<tr>
<td>2</td>
<td></td>
<td>10</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>10</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>4</td>
<td></td>
<td>10</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>5</td>
<td></td>
<td>10</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>Total</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  •  d

Items to be Answered

1. Anker wishes to give Mix power of attorney. In general, the power of attorney

a. May limit Mix’s authority to specific transactions.

b. Must be signed by both Anker and Mix.

c. Will be valid only if Mix is a licensed attorney at law.

d. May continue in existence after Anker’s death.

2. Harris is a purchasing agent for Elkin, a sole proprietor. Harris has the express authority to place purchase orders with Elkin’s suppliers. Harris typically conducts business through the mail and has very little contact with Elkin. Elkin was incapacitated by a stroke and was declared incompetent in a judicial proceeding. Subsequently, Harris placed an order with Ajax, Inc. on behalf of Elkin. Neither Ajax nor Harris were aware of Elkin’s incapacity. With regard to the contract with Ajax, Elkin (or Elkin’s legal representative) will

a. Not be liable because Harris was without authority to enter into the contract.

b. Not be liable provided that Harris had placed orders with Ajax in the past.

c. Be liable because Harris was acting within the scope of Harris’ authority.

d. Be liable because Ajax was unaware of Elkin’s incapacity.

3. Kent Corp. hired Blue as a sales representative for nine months at a salary of $2,000 per month plus 2% of sales. Under the circumstances,

a. Kent does not have the power to dismiss Blue during the nine-month period without cause.

b. The agreement between Kent and Blue is not enforceable unless it is in writing and signed by Blue.

c. The agreement between Kent and Blue formed an agency coupled with an interest.

d. Blue is obligated to act solely in Kent’s interest in matters concerning Kent’s business.

4. In general, which of the following statements is correct with respect to a limited partnership?

a. A limited partner has the right to obtain from the general partner(s) financial information and tax returns of the limited partnership.

b. A limited partnership can be formed with limited liability for all partners.

c. A limited partner may not also be a general partner at the same time.

d. A limited partner may hire employees on behalf of the partnership.

5. Which of the following statements is correct with respect to the differences and similarities between a corporation and a limited partnership?

a. Directors owe fiduciary duties to the corporation and limited partners owe such duties to the partnership.

b. A corporation and a limited partnership may be created only pursuant to a state statute and a copy of its organizational document must be filed with the proper state agency.

c. Shareholders may be entitled to vote on corporate matters whereas limited partners are prohibited from voting on any partnership matters.

d. Stock of a corporation may be subject to the federal securities laws registration requirements whereas limited partnership interests are automatically exempt from such requirements.

6. Krieg’s will created a trust to take effect upon Krieg’s death. The will named Krieg’s spouse as both the trustee and personal representative (executor) of the estate. The will provided that all of Krieg’s securities were to be transferred to the trust and named Krieg’s child as the beneficiary of the trust. Under the circumstances,

a. Krieg has created a testamentary trust.

b. Krieg’s spouse may not serve as both the trustee and personal representative because of the inherent conflict of interest.

c. Krieg has created an inter vivos trust.

d. The trust is invalid because it will not become effective until Krieg’s death.
7. The limited liability of the shareholders of a closely-held corporation will most likely be disregarded if the shareholders
   a. Lend money to the corporation.
   b. Are also corporate officers, directors, or employees.
   c. Undercapitalized the corporation when it was formed.
   d. Formed the corporation solely to limit their personal liability.

Items 8 and 9 are based on the following:

On January 1, 1988, Dix transferred certain assets into a trust. The assets consisted of Lux Corp. bonds with a face amount of $500,000 and an interest rate of 12%. The trust instrument named Dix as trustee, Dix's child as life beneficiary, and Dix's grandchild as remainderman. Interest on the bonds is payable semi-annually on May 1 and November 1. Dix had purchased the bonds at their face amount. As of January 1, 1988, the bonds had a fair market value of $600,000. The accounting period selected for the trust is a calendar year. The trust instrument is silent as to whether Dix may revoke the trust.

8. Which of the following statements is correct?
   a. Dix is not a fiduciary because Dix is also the creator (settlor).
   b. The trust is invalid under the merger doctrine because Dix is both the creator and the trustee.
   c. A duty is owed by Dix to administer the trust property for the sole benefit of the beneficiaries.
   d. Dix has the implied right to revoke the trust without the court's permission.

9. Assuming the trust is valid, how should the amount of interest received in 1988 be allocated between principal and income if the trust instrument is otherwise silent?

<table>
<thead>
<tr>
<th>Principal</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$60,000</td>
</tr>
<tr>
<td>$0</td>
<td>$72,000</td>
</tr>
<tr>
<td>$10,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>$12,000</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

10. The president of Deal Corp. wrote to Boyd, offering to sell the Deal factory for $300,000. The offer was sent by Deal on June 5 and was received by Boyd on June 9. The offer stated that it would remain open until December 20. The offer
   a. Constitutes an enforceable option.
   b. May be revoked by Deal any time prior to Boyd's acceptance.
   c. Is a firm offer under the UCC but will be irrevocable for only three months.
   d. Is a firm offer under the UCC because it is in writing.

Items 11 and 12 are based on the following:

On April 2, Jet Co. wrote to Ard, offering to buy Ard's building for $350,000. The offer contained all of the essential terms to form a binding contract and was duly signed by Jet's president. It further provided that the offer would remain open until May 30 and an acceptance would not be effective until received by Jet. On April 10, Ard accepted Jet's offer by mail. The acceptance was received by Jet on April 14.

11. For this item only, assume that on April 11 Jet sent a telegram to Ard revoking its offer and that Ard received the telegram on April 12. Under the circumstances,
   a. A contract was formed on April 10.
   b. A contract was formed on April 14.
   c. Jet's revocation effectively terminated its offer on April 12.
   d. Jet's revocation effectively terminated its offer on April 11.

12. For this item only, assume that on April 13 Ard sent a telegram to Jet withdrawing the acceptance and rejecting Jet's offer and that Jet received the telegram on April 15. Under the circumstances,
   a. A contract was formed on April 14.
   b. A contract was formed on April 10.
   c. Ard's rejection effectively terminated Jet's offer on April 13.
   d. Ard's rejection effectively terminated Jet's offer on April 15.

13. Parr is the vice-president of research of Lynx, Inc. When hired, Parr signed an employment contract prohibiting Parr from competing with Lynx during and after employment. While employed, Parr acquired knowledge of many of Lynx's trade secrets. If Parr wishes to compete with Lynx and Lynx refuses to give Parr permission, which of the following statements is correct?
   a. Parr has the right to compete with Lynx upon resigning from Lynx.
   b. Parr has the right to compete with Lynx only if fired from Lynx.
   c. In determining whether Parr may compete with Lynx, the court should not consider Parr's ability to obtain other employment.
   d. In determining whether Parr may compete with Lynx, the court should consider, among other factors, whether the agreement is necessary to protect Lynx's legitimate business interests.
14. Payne borrowed $500 from Onest Bank. At the time the loan was made to Payne, Gem orally agreed with Onest that Gem would repay the loan if Payne failed to do so. Gem received no personal benefit as a result of the loan to Payne. Under the circumstances,
   a. Gem is secondarily liable to repay the loan.
   b. Both Gem and Payne are primarily liable to repay the loan.
   c. Gem is free from liability concerning the loan.
   d. Gem is primarily liable to repay the loan.

15. The intent or scienter element necessary to establish a cause of action for fraud will be satisfied if the plaintiff can establish that the
   a. Plaintiff actually relied on the defendant’s misrepresentation.
   b. Plaintiff justifiably relied on the defendant’s misrepresentation.
   c. Defendant made a false representation of fact.
   d. Defendant made a misrepresentation with a reckless disregard for the truth.

16. On April 6, Apple entered into a signed contract with Bean, by which Apple was to sell Bean an antique automobile having a fair market value of $150,000, for $75,000. Apple believed the auto was worth only $75,000. Unknown to either party the auto had been destroyed by fire on April 4. If Bean sues Apple for breach of contract, Apple’s best defense is
   a. Unconscionability.
   b. Risk of loss had passed to Bean.
   c. Lack of adequate consideration.
   d. Mutual mistake.

17. Bond purchased from Spear Corp. an apartment building that was encumbered by a mortgage securing Spear’s promissory note to Fale Finance Co. Bond assumed Spear’s note and mortgage. Subsequently, Bond defaulted on the note payable to Fale and, as a result, the building was sold at a foreclosure sale. If the proceeds of the foreclosure sale are less than the balance due on the note, which of the following statements is correct?
   a. Fale must sue both Spear and Bond to collect the deficiency because they are jointly and severally liable.
   b. Spear will be liable for the deficiency.
   c. Fale must attempt to collect the deficiency from Bond before suing Spear.
   d. Spear will not be liable for the deficiency because Bond assumed the note and mortgage.

18. Pix borrowed $80,000 from Null Bank. Pix gave Null a promissory note and mortgage. Subsequently, Null assigned the note and mortgage to Reed. Reed failed to record the assignment or notify Pix of the assignment. If Pix pays Null pursuant to the note, Pix will
   a. Be primarily liable to Reed for the payments made to Null.
   b. Be secondarily liable to Reed for the payments made to Null.
   c. Not be liable to Reed for the payments made to Null because Reed failed to record the assignment.
   d. Not be liable to Reed for the payments made to Null because Reed failed to give Pix notice of the assignment.

19. Foster Co. and Rice executed a contract by which Foster was to sell a warehouse to Rice for $270,000. The contract required Rice to pay the entire $270,000 at the closing. Foster has refused to close the sale of the warehouse to Rice. If Rice commences a lawsuit against Foster, what relief would Rice likely be entitled to?
   a. Specific performance or compensatory damages.
   b. Specific performance and compensatory damages.
   c. Compensatory damages or punitive damages.
   d. Compensatory damages and punitive damages.

20. Ford was unable to repay a loan from City Bank when due. City refused to renew the loan to Ford unless an acceptable surety could be provided. Ford asked Owens, a friend, to act as surety on the loan. To induce Owens to agree to become a surety, Ford made fraudulent representations about Ford’s financial condition and promised Owens discounts on merchandise sold at Ford’s store. Owens agreed to act as surety and the loan was made to Ford. Subsequently, Ford’s obligation to City was discharged in Ford’s bankruptcy and City wishes to hold Owens liable. Owens may avoid liability
   a. Because the arrangement was void at the inception.
   b. If Owens was an uncompensated surety.
   c. If Owens can show that City Bank was aware of the fraudulent representations.
   d. Because the discharge in bankruptcy will prevent Owens from having a right of reimbursement.

21. Ott and Bane agreed to act as co-sureties on an $80,000 loan that Cread Bank made to Dash. Ott and Bane are each liable for the entire $80,000 loan. Subsequently, Cread released Ott from liability without Bane’s consent and without reserving its rights against Bane. If Dash subsequently defaults, Cread will be entitled to collect a maximum of
   a. $0 from Bane.
   b. $0 from Dash.
   c. $40,000 from Bane.
   d. $40,000 from Dash.
22. Wilk owes a total of $25,000 to eight unsecured creditors and one fully secured creditor. Rusk is one of the unsecured creditors and is owed $7,000. Rusk has filed a petition against Wilk under the liquidation provisions of the Bankruptcy Code. Wilk has been unable to pay Wilk's debts as they become due and Wilk's liabilities exceed Wilk's assets. Wilk has filed the papers that are required to oppose the bankruptcy petition. Which of the following statements is correct?
   a. The petition will be granted because Wilk is unable to pay Wilk's debts as they become due.
   b. The petition will be granted because Wilk's liabilities exceed Wilk's assets.
   c. The petition will be dismissed because three unsecured creditors must join in the filing of the petition.
   d. The petition will be dismissed because the secured creditor failed to join in the filing of the petition.

Items 23 and 24 are based on the following:

On July 15, 1988, White, a sole proprietor, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. White's non-exempt property has been converted to $13,000 cash, which is available to satisfy the following claims:

<table>
<thead>
<tr>
<th>Unsecured claim for 1986</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fee owed to Best &amp; Co., CPAs, for services rendered from April 1, 1988, through June 30, 1988</td>
<td>$6,000</td>
</tr>
<tr>
<td>Unsecured claim by Stieb for wages earned as an employee of White during March, 1988</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

There are no other claims.

23. What is the maximum amount that will be distributed for the payment of the 1986 state income tax?
   a. $4,000
   b. $5,000
   c. $7,000
   d. $10,000

24. What is the maximum amount that will be distributed to Stieb?
   a. $0
   b. $1,000
   c. $2,000
   d. $3,000

Items 25 through 27 are based on the following:

On May 5, 1988, Bold obtained a $90,000 judgment in a malpractice action against Aker, a physician. On June 2, 1988, Aker obtained a $75,000 loan from Tint Finance Co. by knowingly making certain false representations to Tint. On July 7, 1988, Aker filed a voluntary petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. Both Bold and Tint filed claims in Aker's bankruptcy proceeding. Assets in Aker's bankruptcy estate are exempt.

25. Bold's claim
   a. Will be excepted from Aker's discharge in bankruptcy.
   b. Will cause Aker to be denied a discharge in bankruptcy.
   c. Will be set aside as a preference.
   d. Will be discharged in Aker's bankruptcy proceeding.

26. Tint's claim
   a. Will be excepted from Aker's discharge in bankruptcy.
   b. Will cause Aker to be denied a discharge in bankruptcy.
   c. Will be set aside as a preference.
   d. Will be discharged in Aker's bankruptcy proceeding.

27. For this item only, assume that on June 9, 1988, Aker transferred property he owned to his son. The property was collateral for Aker's obligation to Simon. Aker transferred the property with the intent to defraud Simon. Which of the following statements is correct?
   a. Only Simon's debt will be excepted from Aker's discharge in bankruptcy.
   b. Aker will be denied a discharge in bankruptcy.
   c. The transfer will be set aside because it constitutes a preference.
   d. Aker will receive a discharge in bankruptcy of all debts.

28. The Bankruptcy Code provides that a debtor is entitled to claim as exempt property the right to receive

<table>
<thead>
<tr>
<th>Social security benefits</th>
<th>Disability benefits</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>
Business Law

29. Which of the following statements is correct under the reorganization provisions of the Bankruptcy Code?
   a. The court is required to appoint a trustee or an examiner in all cases.
   b. The creditors must appoint a trustee or an examiner after the bankruptcy petition is filed.
   c. The bankruptcy petition may only be filed voluntarily by the debtor.
   d. The court is required to appoint a committee of unsecured creditors.

30. Which of the following statements is correct with respect to social security taxes and benefits?
   a. A self-employed individual with net earnings of $35,000 will pay more tax than an employee with wages of $35,000.
   b. Both employees and self-employed individuals are subject to social security taxes based on their respective gross wages or gross earnings from self-employment.
   c. To the extent the amount received as retirement benefits is less than the amount contributed to the social security fund by the individual, it will never be included in the individual’s adjusted gross income for federal income tax purposes.
   d. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of the individual’s adjusted gross income for federal income tax purposes.

31. Which of the following facts will result in an offering of securities being exempt from registration under the Securities Act of 1933?
   a. The sale or offer to sell the securities is made by a person other than an issuer, underwriter, or dealer.
   b. The securities are non-voting preferred stock.
   c. The issuing corporation was closely held prior to the offering.
   d. The securities are AAA-rated debentures that are collateralized by first mortgages on property that has a market value of 200% of the offering price.

32. A plaintiff wishes to recover damages from the issuer for losses resulting from material misstatements in a securities registration statement. In order to be successful, one of the elements the plaintiff must prove is that the
   a. Plaintiff was in privity of contract with the issuer or that the issuer knew of the plaintiff.
   b. Plaintiff acquired the securities.
   c. Issuer acted negligently.
   d. Issuer acted fraudulently.

33. Which of the following statements is correct concerning corporations subject to the reporting requirements of the Securities Exchange Act of 1934?
   a. The annual report (form 10-K) need not include audited financial statements.
   b. The annual report (form 10-K) must be filed with the SEC within 20 days of the end of the corporation’s fiscal year.
   c. A quarterly report (form 10-Q) need only be filed with the SEC by those corporations that are also subject to the registration requirements of the Securities Act of 1933.
   d. A monthly report (form 8-K) must be filed with the SEC after the end of any month in which a materially important event occurs.

34. Which of the following is a security that is exempt from the registration requirements of the Securities Act of 1933?
   a. Convertible, subordinated debentures issued by a manufacturing company.
   b. Warrants to purchase preferred stock.
   c. Bonds issued by a charitable foundation.
   d. Common stock with a par value of less than $1.00.

35. Gold is holding the following instrument:

```
To: Sussex National Bank
Suffolk, N.Y.

Pay to the order of__ Tom Gold __ $2,000.00

Two Thousand and xx/100 Dollars

on November 1, 1988

Lester Davis

Lester Davis
```

This instrument is a
   a. Postdated check.
   b. Draft.
   c. Promissory note.
   d. Trade acceptance.
36. A bank issues a negotiable instrument that acknowledges receipt of $50,000. The instrument also provides that the bank will repay the $50,000 plus 8% interest per annum to the bearer 90 days from the date of the instrument. The instrument is a
a. Certificate of deposit.
b. Time draft.
c. Trade or banker's acceptance.
d. Cashier's check.

37. Which of the following would cause a promissory note to be nonnegotiable?
   a. An acceleration clause that allows the holder to move up the maturity date of the note in the event of default.
   b. An extension clause that allows the maker to elect to extend the time for payment to a date specified in the note.
   c. A clause that allows the maker to satisfy the note by the performance of services or the payment of money.
   d. A due date is not specified in the note.

38. A secured promissory note would be nonnegotiable if it provided that
   a. Additional collateral must be tendered if there is a decline in market value of the original collateral.
   b. Upon default, the maker waives a trial by jury.
   c. The maker is entitled to a 5% discount if the note is prepaid.
   d. It is subject to the terms of the mortgage given by the maker to the payee.

39. In general, which of the following statements is correct concerning the priority among checks drawn on a particular account and presented to the drawee bank on a particular day?
   a. The checks may be charged to the account in any order convenient to the bank.
   b. The checks may be charged to the account in any order provided no charge creates an overdraft.
   c. The checks must be charged to the account in the order in which the checks were dated.
   d. The checks must be charged to the account in the order of lowest amount to highest amount to minimize the number of dishonored checks.

40. A purchaser of a negotiable instrument would least likely be a holder in due course if, at the time of purchase, the instrument is
   a. Purchased at a discount.
   b. Collateral for a loan.
   c. Payable to bearer on demand.
   d. Overdue by three weeks.

41. Able drew a check payable to the order of Baker. The amount was left blank because it depended on a future delivery of fuel oil to Able, and the exact price was not known at the time the check was issued. Baker estimated the amount at $400, but told Able that in no event would it be more than $600. Baker failed to deliver the fuel oil, but filled in the amount of the check for $800. Baker then negotiated the check to Cook in satisfaction of a $600 debt, with the $200 balance paid to Baker in cash. Able stopped payment and Cook is seeking to collect $800 from Able. Able's maximum liability to Cook will be
   a. $0
   b. $400
   c. $600
   d. $800

42. Which of the following is not a warranty made by the seller of a negotiable warehouse receipt to the purchaser of the document?
   a. The document transfer is fully effective with respect to the goods it represents.
   b. The warehouseman will honor the document.
   c. The seller has no knowledge of any facts that would impair the document’s validity.
   d. The document is genuine.

43. In general, the UCC Sales Article applies to the sale of
   a. Goods only if the seller is a merchant and the buyer is not.
   b. Goods only if the seller and buyer are both merchants.
   c. Consumer goods by a non-merchant.
   d. Real estate by a merchant for $500 or more.

44. Under the UCC Sales Article, a firm offer will be created only if the
   a. Offeree is a merchant.
   b. Offeree gives some form of consideration.
   c. Offer states the time period during which it will remain open.
   d. Offer is made by a merchant in a signed writing.

45. Which of the following factors will be most important in determining whether an express warranty has been created concerning goods sold?
   a. The seller gave a description of the goods that is part of the basis of the bargain.
   b. The buyer or seller is a merchant with respect to the goods being sold.
   c. Whether the seller intended to create the express warranty.
   d. Whether the buyer relied on the seller's statements.
46. If goods have been delivered to a buyer pursuant to a sale or return contract, the
   a. Buyer may use the goods but not resell them.
   b. Seller is liable for the expenses incurred by the buyer in returning the goods to the seller.
   c. Title to the goods remains with the seller.
   d. Risk of loss for the goods passed to the buyer.

47. Which of the following is necessary in order for the warranty of merchantability to arise where there has been a sale of goods?
   I. The seller must be a merchant with respect to goods of that kind.
   II. The warranty must be in writing.
   III. The buyer must have relied on the seller's skill or judgment in selecting the goods.
   a. I and III only.
   b. I, II, and III only.
   c. II and III only.
   d. I only.

48. Cain and Zen Corp. orally agreed that Zen would specially manufacture a machine for Cain at a price of $40,000. After Zen completed the work at a cost of $30,000, Cain notified Zen that it no longer needed the machine. Zen is holding the machine for Cain and has requested payment from Cain. Despite making reasonable efforts, Zen has been unable to resell the machine for any price. Zen has incurred warehouse fees of $500 for storing the machine. If Cain refuses to pay Zen and Zen sues Cain, the most Zen will be entitled to recover is
   a. $0
   b. $30,500
   c. $40,000
   d. $40,500

49. Sutter purchased a computer from Harp. Harp is not in the business of selling computers. Harp tendered delivery of the computer after receiving payment in full from Sutter. Sutter informed Harp that Sutter was unable to take possession of the computer at that time, but would return later that day. Before Sutter returned, the computer was destroyed by a fire. The risk of loss
   a. Remained with Harp, since title had not yet passed to Sutter.
   b. Passed to Sutter upon Harp's tender of delivery.
   c. Remained with Harp, since Sutter had not yet received the computer.
   d. Passed to Sutter at the time the contract was formed and payment was made.

50. Bean ordered 40 beige refrigerators at list price from Tish Co. Immediately upon receipt of Bean's order, Tish sent Bean an acceptance which was received by Bean. The acceptance indicated that shipment would be made within ten days. On the tenth day Tish discovered that all of its supply of beige refrigerators had been sold. Instead it shipped 40 white refrigerators, stating clearly on the invoice that the shipment was sent only as an accommodation. Which of the following is correct?
   a. Bean's order is a unilateral offer, and can only be accepted by Tish's shipment of the goods ordered.
   b. Tish's shipment of white refrigerators is a counteroffer, thus no contract exists between Bean and Tish.
   c. Tish's note of accommodation cancels the contract between Tish and Bean.
   d. Tish's shipment of white refrigerators constitutes a breach of contract.

51. On March 7, 1988, Wax Corp. contracted with Noll Wholesalers to supply Noll with specific electrical parts. Delivery was called for on June 3, 1988. On May 2, 1988, Wax notified Noll that it would not perform and that Noll should look elsewhere. Wax had received a larger and more lucrative contract on April 21, 1988, and its capacity was such that it could not fulfill both orders. The facts
   a. Will prevent Wax from retracting its repudiation of the Noll contract.
   b. Are not sufficient to clearly establish an anticipatory repudiation.
   c. Will permit Noll to sue only after June 3, 1988, the latest performance date.
   d. Will permit Noll to sue immediately after May 2, 1988, even though the performance called for under the contract was not due until June 3, 1988.

52. Mern Corp. is in the business of selling computers and computer software to the public. Mern sold and delivered a personal computer to Whyte on credit. Whyte executed and delivered to Mern a promissory note for the purchase price and a security agreement covering the computer. If Whyte purchased the computer for personal use and Mern fails to file a financing statement, which of the following statements is correct?
   a. The computer was a consumer good while in Mern's possession.
   b. Perfection of Mern's security interest occurred at the time of attachment.
   c. Mern's security interest is not enforceable against Whyte because Mern failed to file a financing statement.
   d. Mern does not have a perfected security interest because it failed to file a financing statement.
53. Dart Co., which is engaged in the business of selling appliances, borrowed $8,000 from Arco Bank. Dart executed a promissory note for that amount and pledged all of its customer installment receivables as collateral for the loan. Dart executed a security agreement which described the collateral, but Arco did not file a financing statement. With respect to this transaction
   a. Attachment of the security interest took place when Dart executed the security agreement.
   b. Attachment of the security interest did not occur because Arco failed to file a financing statement.
   c. Perfection of the security interest occurred despite Arco's failure to file a financing statement.
   d. The UCC Secured Transactions Article does not apply because Arco failed to file a financing statement.

54. With regard to a prior perfected security interest in goods for which a financing statement has been filed, which of the following parties is most likely to have a superior interest in the same collateral?
   a. A buyer in the ordinary course of business who purchased the goods from a merchant.
   b. A subsequent buyer of consumer goods who purchased the goods from another consumer.
   c. The trustee in bankruptcy of the debtor.
   d. Lien creditors of the debtor.

55. Bonn, a secured party, sells collateral at a private sale to a good faith purchaser for value after the debtor defaults. Which of the following statements is correct under the UCC Secured Transactions Article?
   a. In all cases, the collateral will remain subject to the security interests of subordinate lien creditors.
   b. The security interest under which the sale was made and any security interest or lien subordinate to it will be discharged.
   c. In all cases, Bonn may not buy the collateral at a private sale.
   d. Bonn will be entitled to receive a first priority in the sale proceeds.

56. Green and Nunn own a 40-acre parcel of land as joint tenants with the right of survivorship. Nunn wishes to sell the land to Ink. If Nunn alone executes and delivers a deed to Ink, what will be the result?
   a. Green will retain a ½ undivided interest in the 40-acre parcel, and will be unable to set aside Nunn's conveyance to Ink.
   b. Ink will obtain an interest in ½ of the parcel, or 20 acres.
   c. Ink will share ownership of the 40 acres with Green as a joint tenant with a right of survivorship.
   d. The conveyance will be invalid because Green did not sign the deed.

57. Tell, Inc. leased a building from Lott Corp. Tell paid monthly rent of $500 and was also responsible for paying the building's real estate taxes. On January 1, 1987, Vorn Co. and Tell entered into an agreement by which Vorn was entitled to occupy the building for the remainder of the term of Tell's lease in exchange for monthly payments of $600 to Tell. For the year 1987, neither Tell nor Vorn paid the building's real estate taxes and the taxes are delinquent. Learning this, Lott demanded that either Tell or Vorn pay the delinquent taxes. Both refused to do so and Lott has commenced an action against them. Lott will most likely prevail against
   a. Vorn because the lease was assigned to it.
   b. Tell and Vorn because both are jointly and severally liable for the delinquent taxes.
   c. Tell without Vorn because their January 1 agreement constituted a sublease.
   d. Vorn but only to the extent of $100 for each month that it occupied the building during 1987.

58. Which of the following deeds gives the grantee the least amount of protection?
   a. Bargain and sale deed.
   b. Grant deed.
   c. Quitclaim deed.
   d. Warranty deed.

59. In general, a mortgage on real estate
   a. Must be recorded to validate the mortgagee's (lender's) rights against the mortgagor (borrower).
   b. Must be signed by the mortgagor and mortgagee to create an enforceable instrument.
   c. Encumbers the mortgagor's legal title to the real estate.
   d. Gives the mortgagee the right to possess the real estate.

60. In 1982, Smith gave a mortgage to State Bank to secure a $100,000 loan. The mortgage was silent as to whether it would secure any other loans made by State to Smith. In 1984 Smith gave a second mortgage to Penn Bank to secure an $80,000 loan. Both mortgages described the same land and were properly recorded shortly after being executed by Smith. By 1988 Smith had repaid State Bank $40,000 of the $100,000 debt. State Bank then loaned Smith an additional $20,000 without taking any new security. Within a few days, Smith defaulted on the loans from both banks and the first and second mortgages were foreclosed. The balance on the Penn loan was $20,000. The net proceeds of the foreclosure sale were $70,000. State is entitled to receive from the proceeds a maximum of
   a. $52,500.
   b. $56,000.
   c. $60,000.
   d. $70,000.
Number 2 (Estimated time — 15 to 20 minutes)

Dunn & Co., CPAs, while performing the 1987 year-end audit of Starr Corp.'s financial statements discovered that certain events during 1987 had resulted in litigation.

Starr had purchased the warehouse on March 1, 1987. The contract between Birk and Starr provided for a closing on September 20, 1987. On July 1, 1987, Birk executed a contract to purchase the warehouse from Starr for $200,000. On September 1, 1987, Birk contacted Starr and demanded that the purchase price be reduced to $190,000 because of a sudden rise in interest rates and declining value of real estate. Starr orally agreed to change the price to $190,000. On September 2, Birk sent Starr a signed memo confirming the reduction in price to $190,000. Starr did not sign the memo or any other agreement reducing the price. On September 15, Starr, by telephone, informed Birk that it would not sell the warehouse for $190,000. Birk refused to pay Starr $200,000 and a closing never occurred.

On October 30, 1987, a fire caused $80,000 damage to the warehouse at a time when its fair market value was $200,000. Starr had obtained a $160,000 fire insurance policy on February 15, 1987, from Pica Casualty Co., covering the warehouse. On April 11, 1987, Starr obtained another fire insurance policy from Drake Insurance Co. covering the warehouse for $40,000. Each policy contained an 80% coinsurance clause and a provision limiting each company's liability to its proportion of all insurance covering the loss. Pica has refused to pay any amount on its policy.

Starr commenced actions against Birk and Pica asserting the following:

- Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000.
- Starr has an insurable interest in the warehouse covered under the policy with Pica.
- Starr has met the coinsurance requirement under Pica's policy.
- Starr is entitled to recover the entire $80,000 from Pica.

Required: Discuss Starr's assertions, indicating whether such assertions are correct and the reasons therefor.

Number 3 (Estimated time — 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This occurred after Dodd sprayed the chemical in a restaurant that Salam regularly services. Dodd was under the supervision of one of Salam's district managers and was trained by Salam to perform exterminating services following certain procedures, which he did. Later that day several patrons who ate at the restaurant also suffered permanent injuries as a result of inhaling the chemical. The chemical was manufactured by Ace Chemical Corp. and sold and delivered to Salam in a closed container. It was not altered by Salam. It has now been determined that the chemical was defectively manufactured and the injuries suffered by Dodd and the restaurant patrons were a direct result of the defect.

Salam has complied with an applicable compulsory workers' compensation statute by obtaining an insurance policy from Spear Insurance Co.

As a result of the foregoing, the following actions have been commenced:

- Dodd sued Spear to recover workers' compensation benefits.
- Dodd sued Salam based on negligence in training him.
- Dodd sued Ace based on strict liability in tort.
- The restaurant patrons sued Maple claiming negligence in not preventing Salam from using the chemical purchased from Ace.

Required: Discuss the merits of the actions commenced by Dodd and the restaurant patrons, indicating the likely outcomes and your reasons therefor.
Number 4 (Estimated time — 15 to 20 minutes)

On January 5, Stein, Rey, and Lusk entered into a written general partnership agreement by which they agreed to operate a stock brokerage firm. The agreement stated that the partnership would continue upon the death or withdrawal of a partner. The agreement also provided that no partner could reduce the firm’s commission below 2% without the consent of all of the other partners. On March 10, Rey, without the consent of Stein and Lusk, agreed with King Corp. to reduce the commission to 1½% on a large transaction by King. Rey believed this would entice King to become a regular customer of the firm. King was unaware of any of the terms of the partnership agreement.

On May 15, Stein entered into a contract conveying Stein’s partnership interest to Park and withdrew from the partnership. That same day, all of the partners agreed to admit Park as a general partner. Notice of Stein’s withdrawal and Park’s admission as a partner was properly published in two newspapers. In addition, third parties who had conducted business with the partnership prior to May 15 received written notice of Stein’s withdrawal.

Required:

a. In separate paragraphs, discuss whether:
   1. The partnership could recover the ½% commission from King.
   2. The partnership could recover the ½% commission from Rey.

b. In separate paragraphs, discuss:
   1. Park’s liability for partnership obligations arising both before and after being admitted to the partnership.
   2. Stein’s liability for partnership obligations arising both before and after withdrawing from the partnership.

Number 5 (Estimated time — 15 to 20 minutes)

In order to expand its operations, Dark Corp. raised $4 million by making a private interstate offering of $2 million in common stock and negotiating a $2 million loan from Safe Bank. The common stock was properly offered pursuant to Rule 505 of Regulation D.

In connection with this financing, Dark engaged Crea & Co., CPAs, to audit Dark’s financial statements. Crea knew that the sole purpose for the audit was so that Dark would have audited financial statements to provide to Safe and the purchasers of the common stock. Although Crea conducted the audit in conformity with its audit program, Crea failed to detect material acts of embezzlement committed by Dark’s president. Crea did not detect the embezzlement because of its inadvertent failure to exercise due care in designing its audit program for this engagement.

After completing the audit, Crea rendered an unqualified opinion on Dark’s financial statements. The financial statements were relied upon by the purchasers of the common stock in deciding to purchase the shares. In addition, Safe approved the loan to Dark based on the audited financial statements.

Within 60 days after the sale of the common stock and the making of the loan by Safe, Dark was involuntarily petitioned into bankruptcy. Because of the president’s embezzlement, Dark became insolvent and defaulted on its loan to Safe. Its common stock became virtually worthless. Actions have been commenced against Crea by:

* The purchasers of the common stock who have asserted that Crea is liable for damages under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.

* Safe, based upon Crea’s negligence.

Required: In separate paragraphs, discuss the merits of the actions commenced against Crea, indicating the likely outcomes and the reasons therefor.
EXAMINATION IN ACCOUNTING THEORY

(Theory of Accounts)

November 4, 1988; 1:30 to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Point Value</td>
<td>Estimated Minutes</td>
<td></td>
</tr>
<tr>
<td>No. 1</td>
<td>60</td>
<td>90</td>
</tr>
<tr>
<td>No. 2</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>No. 3</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>No. 4</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>No. 5</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>150</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.
Examination Questions — November 1988

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 cash flows.
   d. Retained earnings statement.

Answer Sheet

99. a

Items to be Answered

1. According to the FASB’s conceptual framework, asset valuation accounts are
   a. Assets.
   b. Neither assets nor liabilities.
   c. Part of stockholders’ equity.
   d. Liabilities.

2. The amount by which the aggregate cost of a marketable equity securities portfolio exceeds its aggregate market value should be reported as a valuation allowance when the portfolio is included

   As a current asset                In an unclassified balance sheet
   a. Yes                           No
   b. Yes                           Yes
   c. No                            Yes
   d. No                            No

3. A short-term marketable debt security was purchased on September 1, 1987, between interest dates. The next interest payment date was February 1, 1988. Because of a permanent decline in market value, the cost of the debt security substantially exceeded its market value at December 31, 1987. On the balance sheet at December 31, 1987, the debt security should be carried at
   a. Market value plus the accrued interest paid.
   b. Market value.
   c. Cost plus the accrued interest paid.
   d. Cost.

4. An investor purchased a bond as a long-term investment between interest dates at a premium. At the purchase date, the cash paid to the seller is
   a. The same as the face amount of the bond.
   b. The same as the face amount of the bond plus accrued interest.
   c. More than the face amount of the bond.
   d. Less than the face amount of the bond.

5. An investor uses the equity method to account for an investment in common stock. After the date of acquisition, the investment account of the investor would
   a. Not be affected by its share of the earnings or losses of the investee.
   b. Not be affected by its share of the earnings of the investee, but be decreased by its share of the losses of the investee.
   c. Be increased by its share of the earnings of the investee, but not be affected by its share of the losses of the investee.
   d. Be increased by its share of the earnings of the investee, and decreased by its share of the losses of the investee.

6. According to the net method, which of the following items should be included in the cost of inventory?

   Freight costs       Purchase discounts not taken
   a. Yes              No
   b. Yes              Yes
   c. No              Yes
   d. No              No

7. During periods of rising prices, a perpetual inventory system would result in the same dollar amount of ending inventory as a periodic inventory system under which of the following inventory cost flow methods?

   FIFO                LIFO
   a. Yes              No
   b. Yes              Yes
   c. No              Yes
   d. No              No

8. Under the lower of cost or market method, the replacement cost of an inventory item would be used as the designated market value
   a. When it is below the net realizable value less the normal profit margin.
   b. When it is below the net realizable value and above the net realizable value less the normal profit margin.
   c. When it is above the net realizable value.
   d. Regardless of net realizable value.
9. Which of the following legal fees should be capitalized?

<table>
<thead>
<tr>
<th>Legal fees to</th>
<th>Legal fees to</th>
</tr>
</thead>
<tbody>
<tr>
<td>obtain a franchise</td>
<td>successfully defend a trademark</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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

10. At the end of the accounting period, which of the following costs should be accrued?

<table>
<thead>
<tr>
<th>Liability for federal unemployment taxes</th>
<th>Wages earned but unpaid</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>

11. According to the installment method of accounting, the gross profit on an installment sale is recognized in income:

a. On the date of sale.
b. On the date the final cash collection is received.
c. After cash collections equal to the cost of sales have been received.
d. In proportion to the cash collections received.

12. 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 noncurrent liability, and a deferred income tax charge related to a current liability. Which of the following should be reported in the noncurrent section of the company’s most recent year-end balance sheet:

a. The deferred income tax charge related to a noncurrent liability as a noncurrent asset.
b. The sum of the two deferred income tax charges as a noncurrent asset.
c. The excess of the deferred income tax credit over the two deferred income tax charges as a noncurrent liability.
d. The excess of the deferred income tax credit related to a noncurrent asset over the deferred income tax charge related to a noncurrent liability as a noncurrent liability.

13. A six-year capital lease expiring on December 31 specifies equal minimum annual lease payments. Part of this payment represents interest and part represents a reduction in the net lease liability. The portion of the minimum lease payment in the fifth year applicable to the reduction of the net lease liability should be:

a. Less than in the fourth year.
b. More than in the fourth year.
c. The same as in the sixth year.
d. More than in the sixth year.

14. The issue price of a bond is equal to the present value of the future cash flows for interest and principal when the bond is issued:

<table>
<thead>
<tr>
<th>At par</th>
<th>At a discount</th>
<th>At a premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
<td>Yes</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. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

15. A company issued ten-year term bonds at a discount in 1986. Bond issue costs were incurred at that time. The company uses the effective interest method to amortize bond issue costs. Reporting the bond issue costs as a deferred charge would result in:

a. More of a reduction in net income in 1987 than reporting the bond issue costs as a reduction of the related debt liability.
b. The same reduction in net income in 1987 as reporting the bond issue costs as a reduction of the related debt liability.
c. Less of a reduction in net income in 1987 than reporting the bond issue costs as a reduction of the related debt liability.

16. A ten-year term bond was issued in 1985 at a discount with a call provision to retire the bonds. When the bond issuer exercised the call provision on an interest date in 1987, the carrying amount of the bond was less than the call price. The amount of bond liability removed from the accounts in 1987 should have equaled the:

a. Call price.
b. Call price less unamortized discount.
c. Face amount less unamortized discount.
d. Face amount plus unamortized discount.

17. On December 1, 1987, shares of authorized common stock were issued on a subscription basis at a price in excess of par value. A total of 20% of the subscription price of each share was collected as a down payment on December 1, 1987, with the remaining 80% of the subscription price of each share due in 1988. Collectibility was reasonably assured. At December 31, 1987, the stockholders’ equity section of the balance sheet would report additional paid-in capital for the excess of the subscription price over the par value of the shares of common stock subscribed:

a. Common stock issued for 20% of the par value of the shares of common stock subscribed.
b. Common stock issued for the par value of the shares of common stock subscribed.
c. Common stock subscribed for 80% of the par value of the shares of common stock subscribed.
d. Common stock subscribed for the par value of the shares of common stock subscribed.
18. How would a stock split in which the par value per share decreases in proportion to the number of additional shares issued affect each of the following?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
<th>Progress billings</th>
<th>Collections on progress billings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>No effect</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No effect</td>
<td>No effect</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Increase</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>d. Increase</td>
<td>Decrease</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

19. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect of the subsequent reissuance of the treasury stock on each of the following?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
<th>Total stockholders’ equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Increase</td>
<td>No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

20. A company issued rights to its existing shareholders. The rights were issued without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. Common stock will be increased when the

<table>
<thead>
<tr>
<th>Rights are issued</th>
<th>Rights lapse</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>

21. The partnership of Metcalf, Petersen, and Russell shared profits and losses equally. When Metcalf withdrew from the partnership, the partners agreed that there was unrecorded goodwill in the partnership. Under the bonus method, the capital balances of Petersen and Russell were

a. Not affected.
b. Each reduced by one half of the total amount of the unrecorded goodwill.
c. Each reduced by one third of the total amount of the unrecorded goodwill.
d. Each reduced by one half of Metcalf's share of the total amount of the unrecorded goodwill.

22. A company uses the percentage-of-completion method to account for a four-year construction contract. Which of the following would be used in the calculation of the income recognized in the first year?

a. Yes
b. No

23. An investor uses the cost method to account for an investment in common stock. A portion of the dividends received this year were in excess of the investor's share of investee's earnings subsequent to the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be

a. Zero.
b. The total amount of dividends received this year.
c. The portion of the dividends received this year that were in excess of the investor's share of investee's earnings subsequent to the date of investment.
d. The portion of the dividends received this year that were not in excess of the investor's share of investee's earnings subsequent to the date of investment.

24. Rent should be reported by the lessor as revenue over the lease term as it becomes receivable according to the provisions of the lease for a

<table>
<thead>
<tr>
<th>Direct-financing lease</th>
<th>Operating Lease</th>
<th>Sales-type lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

25. A December 15, 1987, purchase of goods was denominated in a currency other than the entity's functional currency. The transaction resulted in a payable that was fixed in terms of the amount of foreign currency, and was paid on the settlement date, January 20, 1988. The exchange rates between the functional currency and the currency in which the transaction was denominated changed between the transaction date and December 31, 1987, and again between December 31, 1987, and January 20, 1988. Both exchange rate changes resulted in gains. The amount of the gain that should be included in the 1988 financial statements would be

d. Zero.
26. In a periodic inventory system that uses the weighted average cost flow method, the beginning inventory is the
   a. Net purchases minus the ending inventory.
   b. Net purchases minus the cost of goods sold.
   c. Total goods available for sale minus the net purchases.
   d. Total goods available for sale minus the cost of goods sold.

27. A research and development activity for which the cost would be expensed as incurred is
   a. Engineering follow-through in an early phase of commercial production.
   b. Design, construction, and testing of preproduction prototypes and models.
   c. Trouble-shooting in connection with breakdowns during commercial production.
   d. Periodic design changes to existing products.

28. A company received royalties from the assignment of patents to other enterprises. In the period in which the royalties are earned, the royalties should be
   a. Subtracted from the capitalizable cost of the patent.
   b. Amortized to income over the remaining useful life of the patent.
   c. Netted against patent amortization expense.
   d. Reported as revenue.

29. Which of the following components should be included in the calculation of net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan?
<table>
<thead>
<tr>
<th>Interest cost</th>
<th>Actual return on plan assets</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. The liability method of accounting for deferred income taxes should be used for
<table>
<thead>
<tr>
<th>Intraperiod income tax allocation</th>
<th>Permanent 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>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

31. When a segment of a business has been discontinued during the year, the loss on disposal should
   a. Exclude operating losses of the current period up to the measurement date.
   b. Exclude operating losses during the phase-out period.
   c. Be an extraordinary item.
   d. Be an operating item.

32. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of

<table>
<thead>
<tr>
<th>Future periods</th>
<th>The period of change</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>

33. Dilutive stock options would generally be used in the calculation of

<table>
<thead>
<tr>
<th>Primary earnings per share</th>
<th>Fully diluted earnings per share</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>

34. A company's accounts receivable decreased from the beginning to the end of the year. In the company's statement of changes in financial position prepared on a cash basis (direct approach), the cash collected from customers would be
   a. Sales revenues plus accounts receivable at the beginning of the year.
   b. Sales revenues plus the decrease in accounts receivable from the beginning to the end of the year.
   c. Sales revenues less the decrease in accounts receivable from the beginning to the end of the year.
   d. The same as sales revenues.

35. In a statement of changes in financial position prepared on a cash basis (indirect approach), a decrease in prepaid expenses should be
   a. Reported as an inflow and outflow of cash.
   b. Reported as an outflow of cash.
   c. Deducted from income from continuing operations.
   d. Added to income from continuing operations.

36. An entity disposes of a nonmonetary asset in a nonreciprocal transfer. A gain or loss should be recognized on the disposition of the asset when the fair value of the asset transferred is determinable and the nonreciprocal transfer is to

<table>
<thead>
<tr>
<th>Another entity</th>
<th>A stockholder of the entity</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>
37. 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>Interest</th>
<th>Rent</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>

38. If the payment of employees’ compensation for future absences is probable, the amount can be reasonably estimated, and the obligation relates to rights that vest, the compensation should be

a. Recognized when paid.

b. Accrued if attributable to employees’ services whether already rendered or not.

c. Accrued if attributable to employees’ services already rendered.

d. Accrued if attributable to employees’ services not already rendered.

39. Which of the following ratios help users to assess the company’s ability to meet currently maturing or short-term obligations?

<table>
<thead>
<tr>
<th>Dividend payout ratio</th>
<th>Acid-test ratio</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>

40. In a personal statement of financial condition, which of the following should be reported at quoted market prices?

<table>
<thead>
<tr>
<th>Marketable debt securities</th>
<th>Marketable equity securities</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>

41. The fixed portion of the semivariable cost of electricity for a manufacturing plant is a

<table>
<thead>
<tr>
<th>Period cost</th>
<th>Product 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>

42. The completion of goods is recorded as a decrease in work in process control when using

<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>

43. Under the two-variance method for analyzing factory overhead, which of the following is used in the computation of the controllable (budget) 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>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>

44. The sale of scrap from a manufacturing process usually would be recorded as a(an)

a. Decrease in factory overhead control.

b. Increase in factory overhead control.

c. Decrease in finished goods control.

d. Increase in finished goods control.

45. In an income statement prepared as an internal report, operating income would normally be measured under

<table>
<thead>
<tr>
<th>Absorption costing</th>
<th>Variable costing</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>

46. When a flexible budget is used, an increase in production levels within the relevant range would

a. Not change variable costs per unit.

b. Not change total variable costs.

c. Not change fixed costs per unit.

d. Change total fixed costs.

47. Breakeven analysis assumes that over the relevant range total

a. Revenues are linear.

b. Costs are unchanged.

c. Variable costs are nonlinear.

d. Fixed costs are nonlinear.

48. The capital budgeting technique known as net present value uses

<table>
<thead>
<tr>
<th>Cash flow over life of project</th>
<th>Time value of money</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>
Accounting Theory

49. The calculation of 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. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

50. Multiple 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>More than one</td>
</tr>
<tr>
<td>b. More than one</td>
<td>More than one</td>
</tr>
<tr>
<td>c. More than one</td>
<td>One</td>
</tr>
<tr>
<td>d. One</td>
<td>One</td>
</tr>
</tbody>
</table>

51. Which of the following is an appropriate basis of accounting for a proprietary fund of a governmental unit?

<table>
<thead>
<tr>
<th>Cash basis</th>
<th>Modified accrual basis</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>

52. The budget of a governmental unit, for which the appropriations exceed the estimated revenues, was adopted and recorded in the general ledger at the beginning of the year. During the year, expenditures and encumbrances were less than appropriations; whereas revenues equaled estimated revenues. The budgetary fund balance account is

a. Credited at the beginning of the year and not changed at the end of the year.

b. Credited at the beginning of the year and debited at the end of the year.

c. Debited at the beginning of the year and not changed at the end of the year.

d. Debited at the beginning of the year and credited at the end of the year.

53. The appropriations control account of a governmental unit is debited when

<table>
<thead>
<tr>
<th>The budgetary accounts</th>
<th>Expenditures are recorded</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>

54. Which of the following funds of a governmental unit recognizes revenues in the accounting period in which they become available and measurable?

a. Capital projects funds.

b. Nonexpendable trust funds.

c. Enterprise funds.

d. Internal service funds.

55. Which of the following funds of a governmental unit would include retained earnings in its balance sheet?

a. Expendable pension trust.

b. Internal service.

c. Special revenue.

d. Capital projects.

56. Fixed assets should be accounted for in the general fixed assets account group for the

<table>
<thead>
<tr>
<th>Internal service fund</th>
<th>Special revenue 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>

57. Which of the following would appear in the plant fund of a voluntary health and welfare organization?

<table>
<thead>
<tr>
<th>Land</th>
<th>Equipment</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>

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>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. Proceeds from sale of cafeteria meals and guest trays to visitors 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.

60. In a statement of support, revenue, and expenses and changes in fund balances of a voluntary health and welfare organization, contributions to the building fund should

a. Be included as an element of support.

b. Be included as an element of revenue.

c. Be included as an element of other changes in fund balances.

d. Not be included.
Number 2 (Estimated time — 15 to 25 minutes)

Hogan Company uses the net method of accounting for sales discounts. Hogan also offers trade discounts to various groups of buyers.

On August 1, 1987, Hogan factored some accounts receivable on a without recourse basis. Hogan incurred a finance charge.

Hogan also has some notes receivable bearing an appropriate rate of interest. The principal and total interest are due at maturity. The notes were received on October 1, 1987, and mature on September 30, 1989. Hogan's operating cycle is less than one year.

Required:

a.1. Using the net method, how should Hogan account for the sales discounts at the date of sale? What is the rationale for the amount recorded as sales under the net method?

2. Using the net method, what is the effect on Hogan's sales revenues and net income when customers do not take the sales discounts?

b. What is the effect of trade discounts on sales revenues and accounts receivable? Why?

c. How should Hogan account for the accounts receivable factored on August 1, 1987? Why?

d. How should Hogan report the effects of the interest-bearing notes receivable on its December 31, 1987, balance sheet and its income statement for the year ended December 31, 1987? Why?

Number 3 (Estimated time — 15 to 25 minutes)

At the beginning of the year, Patrick Company acquired a computer to be used in its operations. The computer was delivered by the supplier, installed by Patrick, and placed into operation. The estimated useful life of the computer is five years, and its estimated residual (salvage) value is significant.

During the year, Patrick received cash in exchange for an automobile that was purchased in a prior year.

Required:

a.1. What costs should Patrick capitalize for the computer?

2. What is the objective of depreciation accounting? Do not discuss specific methods of depreciation.

b. What is the rationale for using accelerated depreciation methods?

c. How should Patrick account for and report the disposal of the automobile?
Accounting Theory

Number 4 (Estimated time — 15 to 25 minutes)

Skinner Company has the following contingencies:

- Potential costs due to the discovery of a possible defect related to one of its products. These costs are probable and can be reasonably estimated.
- A potential claim for damages to be received from a lawsuit filed this year against another company. It is probable that proceeds from the claim will be received by Skinner next year.
- Potential costs due to a promotion campaign whereby a cash refund is sent to customers when coupons are redeemed. Skinner estimated, based on past experience, that 70 percent of the coupons would be redeemed. Forty percent of the coupons were actually redeemed and the cash refunds sent this year. The remaining 30 percent of the coupons are expected to be redeemed next year.

Required:

a. How should Skinner report the potential costs due to the discovery of a possible product defect? Why?

b. How should Skinner report this year the potential claim for damages that may be received next year? Why?

c. This year, how should Skinner account for the potential costs and obligations due to the promotion campaign?

Number 5 (Estimated time — 15 to 25 minutes)

There are two methods of accounting for business combinations, purchase and pooling of interests.

Required:

a.1. What is the rationale for accounting for a business combination as a purchase? Do not discuss the specific criteria for accounting for a business combination as a purchase.

2. In a business combination accounted for as a purchase, how should the amount of goodwill at acquisition be determined?

3. In a business combination accounted for as a purchase, how should goodwill be amortized?

b.1. What is the rationale for accounting for a business combination as a pooling of interests? Do not discuss the specific criteria for accounting for a business combination as a pooling of interests.

2. In a business combination accounted for as a pooling of interests, when both companies use the same methods of accounting, how should the stockholders' equity be accounted for?
ANSWERS TO EXAMINATION
ACCOUNTING PRACTICE — PART I
November 2, 1988; 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 11. b</td>
<td>21. b 31. d</td>
<td>41. a 51. c</td>
</tr>
<tr>
<td>2. a 12. b</td>
<td>22. a 32. a</td>
<td>42. d 52. a</td>
</tr>
<tr>
<td>3. c 13. a</td>
<td>23. d 33. c</td>
<td>43. b 53. a</td>
</tr>
<tr>
<td>4. b 14. b</td>
<td>24. c 34. d</td>
<td>44. d 54. c</td>
</tr>
<tr>
<td>5. b 15. d</td>
<td>25. b 35. d</td>
<td>45. d 55. d</td>
</tr>
<tr>
<td>6. a 16. c</td>
<td>26. c 36. d</td>
<td>46. a 56. b</td>
</tr>
<tr>
<td>7. d 17. d</td>
<td>27. b 37. a</td>
<td>47. b 57. d</td>
</tr>
<tr>
<td>8. c 18. b</td>
<td>28. a 38. a</td>
<td>48. c 58. d</td>
</tr>
<tr>
<td>9. a 19. b</td>
<td>29. c 39. d</td>
<td>49. d 59. b</td>
</tr>
<tr>
<td>10. a 20. d</td>
<td>30. a 40. a</td>
<td>50. a 60. d</td>
</tr>
</tbody>
</table>

The scores for the multiple choice questions were determined in accordance with the following scales:

**Answer 1**

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0</td>
<td>1½</td>
<td>2</td>
<td>2½</td>
<td>3</td>
<td>3½</td>
<td>4</td>
<td>4½</td>
<td>5</td>
<td>5½</td>
<td>6</td>
<td>6½</td>
<td>7</td>
<td>7½</td>
<td>8</td>
<td>8½</td>
<td>9</td>
<td>9½</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

**Answer 2**

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0</td>
<td>1½</td>
<td>2</td>
<td>2½</td>
<td>3</td>
<td>3½</td>
<td>4</td>
<td>4½</td>
<td>5</td>
<td>5½</td>
<td>6</td>
<td>6½</td>
<td>7</td>
<td>7½</td>
<td>8</td>
<td>8½</td>
<td>9</td>
<td>9½</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

**Answer 3**

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0</td>
<td>1½</td>
<td>2</td>
<td>2½</td>
<td>3</td>
<td>3½</td>
<td>4</td>
<td>4½</td>
<td>5</td>
<td>5½</td>
<td>6</td>
<td>6½</td>
<td>7</td>
<td>7½</td>
<td>8</td>
<td>8½</td>
<td>9</td>
<td>9½</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>
Answer 4 (10 points)

Cord Company
ANALYSIS OF CHANGES IN PLANT ASSETS
For the Year Ended December 31, 1987

<table>
<thead>
<tr>
<th>Balance 12/31/86</th>
<th>Increase</th>
<th>Decrease</th>
<th>Balance 12/31/87</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$175,000</td>
<td>$312,500</td>
<td>$487,500</td>
</tr>
<tr>
<td>Land improvements</td>
<td>—</td>
<td>192,000</td>
<td>$192,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>1,500,000</td>
<td>937,500</td>
<td>2,437,500</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,125,000</td>
<td>385,000</td>
<td>1,493,000</td>
</tr>
<tr>
<td>Automobiles and trucks</td>
<td>172,000</td>
<td>12,500</td>
<td>160,500</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>216,000</td>
<td>—</td>
<td>216,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$3,188,000</td>
<td>$1,839,500</td>
<td><strong>$4,986,500</strong></td>
</tr>
</tbody>
</table>

Explanations of Amounts:

[1] Plant facility acquired from King 1/6/87 — allocation to Land and Building
   Fair value — 25,000 shares of Cord common stock at $50 market price $1,250,000
   Allocation in proportion to appraised values at the exchange date

<table>
<thead>
<tr>
<th>Amount</th>
<th>% to Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$187,500</td>
</tr>
<tr>
<td>Building</td>
<td>562,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$750,000</td>
</tr>
</tbody>
</table>

   Land ($1,250,000 \times 25\%) $312,500
   Building ($1,250,000 \times 75\%) 937,500

[2] Machinery and equipment purchased 7/1/87
   Invoice cost $325,000
   Delivery cost 10,000
   Installation cost 50,000
   **Total acquisition cost** $385,000
b. **Cord Company**

**DEPRECIATION AND AMORTIZATION EXPENSE**

*For the Year Ended December 31, 1987*

**Land improvements**

- Cost: $192,000
- Straight-line rate (100% ÷ 12): × 8 1/3%
- Annual depreciation: 16,000
- Depreciation on land improvements for 1987 (3/25 to 12/31/87): × 3/4 $12,000

**Buildings**

- Carrying amount, 1/1/87 ($1,500,000 - $328,900): $1,171,100
- Building acquired 1/6/87: 937,500
- Total amount subject to depreciation: 2,108,600
- 150% declining balance rate [(100% ÷ 25) × 1.5]: × 6% $126,516

**Machinery and equipment**

- Balance, 1/1/87: $1,125,000
- Straight-line rate (100% ÷ 10): × 10% 112,500
- Purchased 7/1/87: 385,000
- Depreciation for 1987 (10% × 6/12): × 5% 19,250
  - Depreciation on machinery and equipment for 1987: 131,750

**Automobiles and trucks**

- Carrying amount, 1/1/87 ($172,000 - $100,325): $71,675
  - Deduct carrying amount, 1/1/87 on truck sold 9/30/87 ($9,100 + $2,650): 11,750
- Amount subject to depreciation: 59,925
- 150% declining balance rate [(100% ÷ 5) × 1.5]: × 30% 17,978
- Automobile purchased 8/30/87: 12,500
- Depreciation for 1987 (30% × 4/12): × 10% 1,250
- Truck sold 9/30/87 — depreciation for 1987 (1/1 to 9/30/87): 2,650
  - Depreciation on automobiles and trucks for 1987: 21,878

**Leasehold improvements**

- Carrying amount, 1/1/87 ($216,000 - $108,000): $108,000
- Amortization period (1/1/87 to 12/31/91) ÷ 5 years: 5 years
- Amortization in leasehold improvements for 1987: 21,600

**Total depreciation and amortization expense for 1987**: $313,744
a. Peel, Inc. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1987

<table>
<thead>
<tr>
<th>Assets:</th>
<th>Peel, Inc.</th>
<th>Stagg, Inc.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$925,000</td>
<td>$300,000</td>
<td></td>
<td>$1,225,000</td>
</tr>
<tr>
<td>Accounts and other receivables</td>
<td>2,140,000</td>
<td>835,000</td>
<td>[3] $8,000</td>
<td>2,247,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>2,310,000</td>
<td>1,045,000</td>
<td>[4] 720,000</td>
<td>3,265,000</td>
</tr>
<tr>
<td>Land</td>
<td>600,000</td>
<td>330,000</td>
<td></td>
<td>930,000</td>
</tr>
<tr>
<td>Depreciable assets, net</td>
<td>4,525,000</td>
<td>1,980,000</td>
<td></td>
<td>6,505,000</td>
</tr>
<tr>
<td>Investment in Stagg, Inc.</td>
<td>2,430,000</td>
<td></td>
<td>[1] 2,430,000</td>
<td></td>
</tr>
<tr>
<td>Long-term investments and other assets</td>
<td>865,000</td>
<td>385,000</td>
<td>[2] 320,000</td>
<td>930,000</td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td>$15,102,000</td>
</tr>
</tbody>
</table>

Liabilities and stockholders' equity:

<table>
<thead>
<tr>
<th>Accounts payable and other current liabilities</th>
<th>Peel, Inc.</th>
<th>Stagg, Inc.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,465,000</td>
<td>$1,145,000</td>
<td></td>
<td>[3] $8,000</td>
<td>$2,882,000</td>
</tr>
<tr>
<td>[4] 720,000</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>[2] 320,000</td>
<td>2,880,000</td>
</tr>
<tr>
<td>Common stock, $25 par value</td>
<td>3,200,000</td>
<td>1,000,000</td>
<td>[1] 1,000,000</td>
<td>3,200,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,850,000</td>
<td>190,000</td>
<td>[1] 190,000</td>
<td>1,850,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,380,000</td>
<td>1,240,000</td>
<td>[1] 1,240,000</td>
<td>4,290,000</td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td>[5] 90,000</td>
<td>$15,102,000</td>
</tr>
</tbody>
</table>

$3,568,000

$3,568,000
Answer 5 (continued)

b.  *Peel, Inc. and Subsidiary*

**CONSOLIDATED STATEMENT OF RETAINED EARNINGS**  
*For the Year Ended December 31, 1987*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 1986:</td>
<td></td>
</tr>
<tr>
<td>As originally reported</td>
<td>$2,506,000</td>
</tr>
<tr>
<td>Adjustment for pooling of interests with Stagg, Inc.</td>
<td>820,000</td>
</tr>
<tr>
<td>As restated</td>
<td>3,326,000</td>
</tr>
<tr>
<td>Net income</td>
<td>1,380,000 [6]</td>
</tr>
</tbody>
</table>

Deduct cash dividends paid:
- By Stagg, Inc., prior to combination: 160,000 [7]
- By Peel, Inc., after the combination: 256,000

Balance, December 31, 1987: $4,290,000

**Explanations of Worksheet Entries & Other Amounts**

1. To eliminate the reciprocal elements in investment and equity accounts.
2. To eliminate Peel’s investment in Stagg’s bonds.
3. To eliminate Peel’s intercompany accrued interest receivable on its investment in Stagg’s bonds for the period 10/1 - 12/31/87. ($320,000 \times 10\% \times \frac{1}{4} = $8,000)
4. To eliminate Peel’s intercompany balance for merchandise owed by Stagg.
5. To eliminate intercompany profit in ending inventory of Stagg. ($180,000 \times \frac{1}{2} = $90,000)
6. Consolidated net income for 1987
   - Peel, Inc.: $890,000
   - Stagg, Inc.: $580,000
   - Deduct intercompany profit in inventory: 90,000 [5]
   - Total: $1,380,000
7. Dividend paid 6/15/87
   - [40,000 shares \times $4]: $160,000
ANSWERS TO EXAMINATION
ACCOUNTING PRACTICE — PART II

November 3, 1988; 1:30 P.M. to 6:00 P.M.

<table>
<thead>
<tr>
<th>Answer 1 (10 points)</th>
<th>Answer 2 (10 points)</th>
<th>Answer 3 (10 points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. c</td>
<td>11. a</td>
<td>31. c</td>
</tr>
<tr>
<td>2. d</td>
<td>12. d</td>
<td>32. a</td>
</tr>
<tr>
<td>3. b</td>
<td>13. a</td>
<td>33. d</td>
</tr>
<tr>
<td>4. a</td>
<td>14. b</td>
<td>34. b</td>
</tr>
<tr>
<td>5. d</td>
<td>15. b</td>
<td>35. d</td>
</tr>
<tr>
<td>6. a</td>
<td>16. c</td>
<td>36. b</td>
</tr>
<tr>
<td>7. c</td>
<td>17. c</td>
<td>37. c</td>
</tr>
<tr>
<td>8. b</td>
<td>18. c</td>
<td>38. a</td>
</tr>
<tr>
<td>9. d</td>
<td>19. d</td>
<td>39. c</td>
</tr>
<tr>
<td>10. d</td>
<td>20. b</td>
<td>40. a</td>
</tr>
</tbody>
</table>

The scores for the multiple choice questions were determined in accordance with the following scales:

**Answer 1**

| Correct | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 0 | 1½| 2 | 2½| 3 | 3½| 4 | 4½| 5 | 5½| 6 | 6½ | 7 | 7½ | 8 | 8½ | 9 | 9½ | 10 | 10 | 10 | 10 |

**Answer 2**

| Correct | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 0 | 2 | 2½| 3 | 3½| 4 | 4½| 5 | 5½| 6 | 6½ | 7 | 7½ | 8 | 8½ | 9 | 9½ | 10 | 10 | 10 | 10 |

**Answer 3**

| Correct | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 0 | 2 | 2½| 3 | 3½| 4 | 4½| 5 | 5½| 6 | 6½ | 7 | 7½ | 8 | 8½ | 9 | 9½ | 10 | 10 | 10 | 10 |
Answer 4 (10 points)

a. Lino Corporation
LONG-TERM LIABILITIES SECTION
OF BALANCE SHEET
December 31, 1987

10% note payable to bank, due in annual installments of $200,000, less current installment $ 400,000 [1]

Liability under capital lease, net present value of lease payments, less current installment 160,768 [2]

10% bonds payable due July 1, 1997, less unamortized discount of $243,750 756,250 [3]

Deferred income taxes 115,000 [4]

Total long-term liabilities $1,432,018

b. Lino Corporation
INTEREST EXPENSE
For the Year Ended December 31, 1987

Note payable to bank $ 75,000 [5]
Liability under capital lease 44,800 [2]
Bonds payable 56,250 [3]

Total $ 176,050
**Answer 4 (continued)**

**Explanations of Amounts**

[1] 10% Note payable to bank
- Note payable, 12/31/86 | $800,000
- Less installment paid 10/1/87 | 200,000
- Balance, 12/31/87 | 600,000
- Less current installment due 10/1/88 | 200,000
- Long-term portion, 12/31/87 | $400,000

<table>
<thead>
<tr>
<th>Note</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$800,000</td>
<td>200,000</td>
</tr>
<tr>
<td>600,000</td>
<td>200,000</td>
</tr>
<tr>
<td>400,000</td>
<td></td>
</tr>
</tbody>
</table>

[2] Liability under capital lease
- Liability under capital lease, 12/31/86 | $280,000
- Less principal portion of 12/31/87 payment
  - Lease payment | $100,000
  - Less imputed interest ($280,000 × 16%) | 44,800
  - Balance, 12/31/87 | 224,800
- Less current principal payment due 12/31/88
  - Lease payment | 100,000
  - Less imputed interest ($224,800 × 16%) | 35,968
  - Long-term portion, 12/31/87 | $160,768

<table>
<thead>
<tr>
<th>Note</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>280,000</td>
<td></td>
</tr>
<tr>
<td>100,000</td>
<td>44,800</td>
</tr>
<tr>
<td>224,800</td>
<td></td>
</tr>
<tr>
<td>100,000</td>
<td>35,968</td>
</tr>
<tr>
<td>160,768</td>
<td></td>
</tr>
</tbody>
</table>

[3] Bonds payable
- Bonds payable issued 7/1/87 | $750,000
- Add amortization of bond discount
  - Effective interest ($750,000 × 15% × %12) | 56,250
  - Less accrued interest payable 12/31/87
    ($1,000,000 × 10% × %12) | 50,000
  - Balance, 12/31/87 | $756,250

<table>
<thead>
<tr>
<th>Note</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>750,000</td>
<td></td>
</tr>
<tr>
<td>56,250</td>
<td>50,000</td>
</tr>
<tr>
<td>756,250</td>
<td></td>
</tr>
</tbody>
</table>

[4] Deferred income taxes
- Deferred income taxes, 12/31/86 | $100,000
- Add timing difference — excess of tax depreciation over book depreciation of $50,000 × 30%
  - Balance, 12/31/87 | $115,000

<table>
<thead>
<tr>
<th>Note</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>115,000</td>
<td></td>
</tr>
</tbody>
</table>

[5] Interest expense on note payable to bank
- 1/1/87 to 9/30/87 ($800,000 × 10% × %12) | $ 60,000
- 10/1/87 to 12/31/87 ($600,000 × 10% × %12) | 15,000
- Interest, year ended 12/31/87 | $ 75,000

<table>
<thead>
<tr>
<th>Note</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>75,000</td>
<td></td>
</tr>
</tbody>
</table>
Answer 5 (10 points)

Amar Supermarkets Corp.

Plan 1

ALLOCATION OF CORPORATION OVERHEAD
ON THE BASIS OF SALES
For the Year Ended December 31, 1987

<table>
<thead>
<tr>
<th>Store</th>
<th>Allocation</th>
<th>Corporation overhead</th>
<th>Income before corporation overhead</th>
<th>Income after corporation overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Birch</td>
<td>( \frac{5}{12} = 42% )</td>
<td>$42,000</td>
<td>$84,000</td>
<td>$42,000</td>
</tr>
<tr>
<td>Maple</td>
<td>( \frac{4}{12} = 33% )</td>
<td>33,000</td>
<td>37,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Spruce</td>
<td>( \frac{3}{12} = 25% )</td>
<td>25,000</td>
<td>29,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>$100,000</td>
<td>$150,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

Plan 2

ALLOCATION OF CORPORATION OVERHEAD
ON VARIOUS BASES
For the Year Ended December 31, 1987

<table>
<thead>
<tr>
<th>Total</th>
<th>Warehouse operations</th>
<th>Store</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Birch</td>
<td>Maple</td>
</tr>
<tr>
<td>Income before corporation overhead</td>
<td>$150,000</td>
<td>$84,000</td>
</tr>
<tr>
<td>Warehouse operations</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Central office salaries</td>
<td>30,000</td>
<td>7,500</td>
</tr>
<tr>
<td>Other central office overhead</td>
<td>2,000</td>
<td>500</td>
</tr>
<tr>
<td>Total warehouse operations</td>
<td>23,000</td>
<td>$23,000</td>
</tr>
<tr>
<td>Warehouse depreciation</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>8,000</td>
<td></td>
</tr>
<tr>
<td>Total — allocated on basis of sales</td>
<td>41,000</td>
<td>17,220</td>
</tr>
<tr>
<td>Delivery expenses — allocated on basis of miles times deliveries</td>
<td>35,000</td>
<td>17,500</td>
</tr>
<tr>
<td>15,000/30,000 = 50%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10,000/30,000 = 33%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5,000/30,000 = 17%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total corporation overhead</td>
<td>100,000</td>
<td>42,720</td>
</tr>
<tr>
<td>Income after corporation overhead</td>
<td>$50,000</td>
<td>$41,280</td>
</tr>
</tbody>
</table>
Answer 5 (continued)

b. **Amar Supermarkets Corp.**

**COMPUTATION OF COST INCREASES RESULTING FROM PROSPECTIVE INCREASE IN SALES**

<table>
<thead>
<tr>
<th>Store</th>
<th>Sales — 1987</th>
<th>Cost of sales — 1987</th>
<th>Local variable operating expenses</th>
<th>Total local variable costs</th>
<th>Percent of local variable costs to sales</th>
<th>Multiplied by prospective increase in sales</th>
<th>Increase in local variable costs</th>
<th>*Increase in delivery expenses</th>
<th>Increase in relevant expenses</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Birch</td>
<td>$500,000</td>
<td>$280,000</td>
<td>66,000</td>
<td>$346,000</td>
<td>69%</td>
<td>$80,000</td>
<td>55,200</td>
<td>1,170</td>
<td></td>
<td>$700,000</td>
</tr>
<tr>
<td>Maple</td>
<td>$400,000</td>
<td>$230,000</td>
<td>73,000</td>
<td>$303,000</td>
<td>76%</td>
<td>$80,000</td>
<td>60,800</td>
<td>2,340</td>
<td></td>
<td>700,000</td>
</tr>
<tr>
<td>Spruce</td>
<td>$300,000</td>
<td>$190,000</td>
<td>31,000</td>
<td>$221,000</td>
<td>74%</td>
<td>$80,000</td>
<td>59,200</td>
<td>293</td>
<td></td>
<td>700,000</td>
</tr>
</tbody>
</table>

Management should expand the Birch store because costs would increase the least and net income would increase the most. Differential revenues would be the same for all stores, but differential costs would be the least at Birch. Therefore, differential net income would be greatest at Birch.

**COMPUTATION OF INCREASE IN DELIVERY EXPENSES**

<table>
<thead>
<tr>
<th>Store</th>
<th>Miles from warehouse</th>
<th>Additional deliveries</th>
<th>Additional delivery miles</th>
<th>Cost per delivery mile</th>
<th>Total increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Birch</td>
<td>100</td>
<td>10</td>
<td>1,000</td>
<td>$1.17</td>
<td>$1,170</td>
</tr>
<tr>
<td>Maple</td>
<td>200</td>
<td>10</td>
<td>2,000</td>
<td>1.17</td>
<td>2,340</td>
</tr>
<tr>
<td>Spruce</td>
<td>25</td>
<td>10</td>
<td>250</td>
<td>1.17</td>
<td>293</td>
</tr>
</tbody>
</table>

\[
\text{Cost per delivery mile} = \frac{\text{Delivery expenses in 1987}}{\text{Delivery miles in 1987}} = \frac{35,000}{30,000} = \$1.17
\]
Answer 1 (60 points)

1. c  11. b  21. b  31. b  41. a  51. d
2. d  12. a  22. a  32. b  42. a  52. d
3. a  13. a  23. b  33. b  43. b  53. c
4. a  14. c  24. c  34. a  44. c  54. b
5. c  15. c  25. a  35. d  45. d  55. a
6. a  16. c  26. b  36. a  46. a  56. c
7. d  17. d  27. a  37. d  47. c  57. a
8. c  18. d  28. d  38. b  48. c  58. b
9. b  19. a  29. d  39. c  49. b  59. b
10. d  20. d  30. c  40. b  50. c  60. b

The scores for the multiple choice questions were determined in accordance with the following scales:

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>15</td>
<td>16</td>
<td>17</td>
<td>18</td>
<td>19</td>
<td>20</td>
<td>21</td>
<td>22</td>
<td>23</td>
<td>24</td>
<td>25</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Correct</th>
<th>21</th>
<th>22</th>
<th>23</th>
<th>24</th>
<th>25</th>
<th>26</th>
<th>27</th>
<th>28</th>
<th>29</th>
<th>30</th>
<th>31</th>
<th>32</th>
<th>33</th>
<th>34</th>
<th>35</th>
<th>36</th>
<th>37</th>
<th>38</th>
<th>39</th>
<th>40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>26</td>
<td>27</td>
<td>28</td>
<td>29</td>
<td>30</td>
<td>31</td>
<td>32</td>
<td>33</td>
<td>34</td>
<td>35</td>
<td>36</td>
<td>37</td>
<td>38</td>
<td>39</td>
<td>40</td>
<td>41</td>
<td>42</td>
<td>43</td>
<td>44</td>
<td>45</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Correct</th>
<th>41</th>
<th>42</th>
<th>43</th>
<th>44</th>
<th>45</th>
<th>46</th>
<th>47</th>
<th>48</th>
<th>49</th>
<th>50</th>
<th>51</th>
<th>52</th>
<th>53</th>
<th>54</th>
<th>55</th>
<th>56</th>
<th>57</th>
<th>58</th>
<th>59</th>
<th>60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>46</td>
<td>47</td>
<td>48</td>
<td>49</td>
<td>50</td>
<td>51</td>
<td>52</td>
<td>53</td>
<td>54</td>
<td>55</td>
<td>56</td>
<td>57</td>
<td>58</td>
<td>59</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>60</td>
</tr>
</tbody>
</table>

N-66
Answer 2 (10 points)

The audit procedures Temple should apply to identify Ford's related party relationships and transactions include the following:

- Evaluate the company's procedures for identifying and properly reporting related party relationships and transactions.
- Request from management the names of all related parties and inquire whether there were any transactions with these parties during the period.
- Review tax returns and filings with other regulatory agencies for the names of related parties.
- Determine the names of all pension plans and other trusts and the names of their officers and trustees.
- Review stock certificate book to identify the stockholders.
- Review material investment transactions to determine whether the investments created related party relationships.
- Review the minutes of board of directors' meetings.
- Review conflict-of-interest statements obtained by the company from its management.
- Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders.
- Consider whether transactions are occurring, but are not being given proper accounting recognition, e.g. personal use of company vehicles, interest-free loans, etc.
- Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
- Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- Review invoices from law firms that have performed services for the company for indications of the existence of related party relationships or transactions.
- Review confirmations of loans receivable and payable for indications of guarantees, and determine their nature and the relationships, if any, of the guarantors to the reporting entity.

Answer 3 (10 points)

a. 1. In determining an acceptable level of risk of overreliance, an auditor should consider the importance of the control to be tested in determining the extent to which substantive tests will be restricted and the planned degree of reliance on that control.

2. In determining the tolerable deviation rate, an auditor should consider the planned degree of reliance on the control to be tested and how materially the financial statements would be affected if the control does not function properly. For example, how likely is the control to prevent or detect material errors.

3. In determining the expected population deviation rate, an auditor should consider the results of prior years' tests, the overall control environment, or utilize a preliminary sample.

b. 1. There is a decrease in sample size if the acceptable level of risk of overreliance is increased.

2. There is a decrease in sample size if the tolerable deviation rate is increased.

3. There is an increase in sample size if the population deviation rate is increased.

c. For a low risk of overreliance it is generally appropriate to reconsider the planned reliance as the calculated estimate of the population deviation rate identified in the sample (7%) approaches the tolerable deviation rate (8%). This is because there may be an unacceptably high sampling risk that these sample results could have occurred with an actual population deviation rate higher than the tolerable deviation rate.

d. If statistical sampling is used, an allowance for sampling risk can be calculated. If the calculated estimate of the population deviation rate plus the allowance for sampling risk is greater than the tolerable deviation rate, the sample results should be interpreted as not supporting the planned reliance on the control.
Examination Answers — November 1988

Answer 4 (10 points)

Deficiencies in the staff assistant’s draft are as follows:

Within the first paragraph

• The statement of cash flow is not identified.
• Standards established by the AICPA, not generally accepted auditing standards, should be referred to.
• The financial statements are not stated to be the representations of management.
• The phrase “our review included such tests of the accounting records as we considered necessary in the circumstances” is inappropriate.

Within the second paragraph

• The phrase “analytical procedures applied to financial data” is omitted.
• The phrase “more in scope than a compilation” is inappropriate.
• An opinion should be disclaimed.
• “Limited assurance” should not be expressed.

Within the third paragraph

• Reference to the “exception” in the third paragraph when it has been restated is inappropriate.
• Reference to consistency is inappropriate.

Within the fourth paragraph

• There should be reference to the prior year’s review report.
• There should be reference to generally accepted accounting principles.

Answer 5 (10 points)

a. The means or techniques of gathering audit evidence, in addition to the example, are as follows:

<table>
<thead>
<tr>
<th>Technique</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inquiry</td>
<td>An auditor questions client personnel about events and conditions, such as obsolete inventory.</td>
</tr>
<tr>
<td>Confirmation</td>
<td>An auditor obtains acknowledgments in writing from third parties of transactions or balances, such as inventory in public warehouses or on consignment.</td>
</tr>
<tr>
<td>Calculation or Recomputation</td>
<td>An auditor recomputes certain amounts, such as the multiplication of quantity times price to determine inventory amounts.</td>
</tr>
<tr>
<td>Analysis</td>
<td>An auditor combines amounts in meaningful ways to allow the application of audit judgment, such as the determination of whether a proper inventory cutoff was performed.</td>
</tr>
<tr>
<td>Inspection</td>
<td>An auditor examines documents relating to transactions and balances, such as shipping and receiving records to establish ownership of inventory.</td>
</tr>
<tr>
<td>Comparison</td>
<td>An auditor relates two or more amounts, such as inventory cost in perpetual inventory records to costs as shown on vendor invoices as part of the evaluation of whether inventory is priced at the lower of cost or market.</td>
</tr>
</tbody>
</table>
**Answer 5 (continued)**

b. Substantive auditing procedures that would satisfy the five general assertions regarding a client's inventory balance include the following:

(one different procedure required for each assertion)

<table>
<thead>
<tr>
<th>Assertion</th>
<th>Substantive Auditing Procedure</th>
</tr>
</thead>
</table>
| 1. Existence or Occurrence | • Observe physical inventory counts.  
|                     | • Obtain confirmation of inventories at locations outside the entity.  
|                     | • Test inventory transactions between a preliminary physical inventory date and the balance sheet date.  
|                     | • Review perpetual inventory records, production records, and purchasing records for indications of current activity.  
|                     | • Compare inventories with a current sales catalog and subsequent sales and delivery reports.  
|                     | • Use the work of specialists to corroborate the nature of specialized products. |
| 2. Completeness    | • Observe physical inventory counts.  
|                     | • Analytically review the relationship of inventory balances to recent purchasing, production, and sales activities.  
|                     | • Test shipping and receiving cutoff procedures.  
|                     | • Obtain confirmation of inventories at locations outside the entity.  
|                     | • Trace test counts recorded during the physical inventory observation to the inventory listing.  
|                     | • Account for all inventory tags and count sheets used in recording the physical inventory counts.  
|                     | • Test the clerical accuracy of inventory listings.  
|                     | • Reconcile physical counts to perpetual records and general ledger balances and investigate significant fluctuations. |

**Answer 5 (continued)**

<table>
<thead>
<tr>
<th>Assertion</th>
<th>Substantive Auditing Procedure</th>
</tr>
</thead>
</table>
| 3. Rights and Obligations | • Observe physical inventory counts.  
|                     | • Obtain confirmation of inventories at locations outside the entity.  
|                     | • Examine paid vendors' invoices, consignment agreements, and contracts.  
|                     | • Test shipping and receiving cutoff procedures.  
| 4. Valuation or Allocation | • Examine paid vendors' invoices.  
|                     | • Review direct labor rates.  
|                     | • Test the computation of standard overhead rates.  
|                     | • Examine analyses of purchasing and manufacturing standard cost variances.  
|                     | • Examine an analysis of inventory turnover.  
|                     | • Review industry experience and trends.  
|                     | • Analytically review the relationship of inventory balances to anticipated sales volume.  
|                     | • Tour the plant.  
|                     | • Inquire of production and sales personnel concerning possible excess or obsolete inventory items.  
|                     | • Obtain current market value quotations.  
|                     | • Review current production costs.  
|                     | • Examine sales after year-end and open purchase order commitments.  
| 5. Presentation and Disclosure | • Review drafts of the financial statements.  
|                     | • Compare the disclosures made in the financial statements to the requirements of generally accepted accounting principles.  
|                     | • Obtain confirmation of inventories pledged under loan agreements. |
ANSWERS TO EXAMINATION

BUSINESS LAW
(Commercial Law)

November 4, 1988; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. a 11. c 21. c 31. a 41. d 51. d
2. a 12. a 22. a 32. b 42. b 52. b
3. d 13. d 23. d 33. d 43. c 53. a
4. a 14. c 24. b 34. c 44. d 54. a
5. b 15. d 25. d 35. b 45. a 55. b
6. a 16. d 26. a 36. a 46. d 56. a
7. c 17. b 27. b 37. c 47. d 57. c
8. c 18. d 28. c 38. c 48. b 58. c
9. c 19. a 29. d 39. a 49. b 59. c
10. b 20. c 30. a 40. d 50. d 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>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
<th>14</th>
<th>15</th>
<th>16</th>
<th>17</th>
<th>18</th>
<th>19</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>0</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>15</td>
<td>16</td>
<td>17</td>
<td>18</td>
<td>19</td>
<td>20</td>
<td>21</td>
<td>22</td>
<td>23</td>
<td>24</td>
<td>25</td>
<td>26</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Correct</th>
<th>21</th>
<th>22</th>
<th>23</th>
<th>24</th>
<th>25</th>
<th>26</th>
<th>27</th>
<th>28</th>
<th>29</th>
<th>30</th>
<th>31</th>
<th>32</th>
<th>33</th>
<th>34</th>
<th>35</th>
<th>36</th>
<th>37</th>
<th>38</th>
<th>39</th>
<th>40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td>27</td>
<td>28</td>
<td>29</td>
<td>30</td>
<td>31</td>
<td>32</td>
<td>33</td>
<td>34</td>
<td>35</td>
<td>36</td>
<td>37</td>
<td>38</td>
<td>39</td>
<td>40</td>
<td>41</td>
<td>42</td>
<td>43</td>
<td>44</td>
<td>45</td>
<td>46</td>
</tr>
</tbody>
</table>

| Correct |41 |42 |43 |44 |45 |46 |47 |48 |49 |50 |51 |52 |53 |54 |55 |56 |57 |58 |59 |60  |
| Score   |47 |48 |49 |50 |51 |52 |53 |54 |55 |56 |57 |58 |59 |60 |60 |60 |60 |60 |60 |60  |

N-70
**Answer 2 (10 points)**

Starr’s first assertion, that Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000, is correct. An oral agreement modifying an enforceable existing contract is not enforceable if the modification is within the statute of frauds. A contract for the sale of real estate or a modification of such a contract falls within the provisions of the statute of frauds and therefore a writing signed by the party to be charged is required. The fact that Birk sent a signed memo to Starr is not effective because it was not signed by Starr. Furthermore, the agreement to reduce the purchase price to $190,000 is not enforceable because Birk did not give any consideration for the modification. Birk had a pre-existing obligation to purchase the warehouse for $200,000 and gave no new consideration for the modification of the price. The fact that Birk may have acted in good faith as a result of the decline in value of real estate and rise in interest rates will not be sufficient to make the oral agreement enforceable against Starr. Therefore, Birk’s failure to pay $200,000 as required by the July 1 contract constitutes a breach of that contract.

Starr’s second assertion, that it has an insurable interest in the warehouse covered by the Pica policy, is correct. To constitute an insurable interest the element of financial or economic loss to the insured must be present. Furthermore, the insurable interest must be present at the time of the loss but need not be present at the time the policy was issued. Under the facts of this case, Starr had an insurable interest on the date of the loss (October 30) since it owned the warehouse on that date. Whether Starr had an insurable interest on February 15 will not affect Starr’s right to recover from Pica.

Starr’s third assertion, that it has met the coinsurance requirement under Pica’s policy is correct.

Starr’s fourth assertion, that Starr is entitled to recover the entire $80,000 from Pica is incorrect. Starr is only entitled to receive $64,000 from Pica calculated as follows:

\[
\text{Amount of Insurance Coverage with Pica} \times \frac{\text{Amount to be Paid}}{\text{Total Amount of Insurance on Warehouse}} = \text{Amount to be Paid}
\]

Thus, Pica’s liability is limited to the amount its policy bears to the total amount of insurance on the warehouse.

**Answer 3 (10 points)**

Dodd is entitled to recover workers’ compensation benefits from Spear because Dodd was an employee of Salam, the injury was accidental, and the injury occurred out of and in the course of his employment with Salam. Based on the facts of this case, Dodd would be considered an employee and not an independent contractor because Salam had control over the details of Dodd’s work by training Dodd to perform the services in a specified manner and Dodd was subject to Salam’s supervision.

Dodd will be unsuccessful in his action against Salam based on negligence in training him because Dodd is an employee of Salam and Salam has complied with the applicable compulsory workers’ compensation statute by obtaining workers’ compensation insurance. Under workers’ compensation, an employee who receives workers’ compensation benefits cannot successfully maintain an action for negligence against his employer seeking additional compensation. Therefore, whether Salam was negligent in training Dodd is irrelevant.

Dodd’s action against Ace based on strict liability in tort will be successful. Generally, in order to establish a cause of action based on strict liability in tort, it must be shown that: the product was in defective condition when it left the possession or control of the seller; the product was unreasonably dangerous to the consumer or user; the cause of the consumer’s or user’s injury was the defect; the seller engaged in the business of selling such a product; the product was one which the seller expected to, and, did reach the consumer or user without substantial changes in the condition in which it was sold. Under the facts of this case, Ace will be liable based on strict liability in tort because all of the elements necessary to state such a cause of action have been met. The fact that Dodd is entitled to workers’ compensation benefits does not preclude Dodd from recovering based on strict liability in tort from a third party (Ace).

Maple will not be liable to the restaurant patrons based on negligence, because shareholders of a corporation are insulated from personal liability for the negligence of the corporation or the corporation’s employees. This rule would apply even though Maple owned a controlling interest in the common stock of Salam. Therefore, whether Salam or Dodd was negligent is irrelevant.
Answer 4 (10 points)

a.1. The partnership cannot recover the ½% commission from King because Rey had the apparent authority to reduce the commission to 1½%. The Uniform Partnership Act states that every partner is an agent of the partnership for the purpose of its business, and the act of every partner for apparently carrying on in the usual way the business of the partnership, binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom the partner is dealing has knowledge of the fact that the partner has no such authority. In determining whether Rey had the apparent authority to bind the partnership, one must examine the circumstances and conduct of the parties and whether King reasonably believed such authority to exist. Because brokerage commissions are generally not uniform, it would be reasonable for King to believe that Rey had the authority to perform the transaction at 1½% commission. Furthermore, King lacked knowledge of the restriction in the partnership agreement that prohibited Rey from reducing a commission below 2% without the partners' consent. Therefore, King will not be liable for the ½% commission.

a.2. The partnership can recover the ½% commission from Rey because Rey violated the partnership agreement by reducing the commission to 1½% without the partners' consent. Rey owes a duty to act in accordance with the partnership agreement.

b.1. Under the Uniform Partnership Act, a person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before being admitted as though that person had been a partner when such obligations were incurred, except that this liability may be satisfied only out of partnership property. Thus, Park will not be personally liable for the partnership obligations arising prior to being admitted as a partner but would be liable based upon the extent of partnership interests held. Park will be personally liable for partnership obligations arising after being admitted to the partnership.

b.2. Stein will continue to be personally liable for partnership obligations arising prior to withdrawing from the partnership, unless Stein obtains a release from the existing creditors. Stein will have no liability for partnership obligations arising after actual and constructive notice of withdrawing was properly given. However, Stein may be personally liable for partnership obligations arising after withdrawing but prior to notice being given. Actual notice of Stein's withdrawal was given by written notification to partnership creditors that had conducted business with the partnership prior to May 15. Constructive notice of Stein's withdrawal was given by proper publication in two newspapers to those third parties who had not dealt with the partnership, but may have known of its existence.

Answer 5 (10 points)

Crea will not be liable to the purchasers of the common stock. Although an offering of securities made pursuant to Regulation D is exempt from the registration requirements of the Securities Act of 1933, the antifraud provisions of the federal securities acts continue to apply. In order to establish a cause of action under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, the purchasers generally must show that: Crea made a material misrepresentation or omission in connection with the purchase or sale of a security; Crea acted with some element of scienter (intentional or willful conduct); Crea's wrongful conduct was material; the purchasers relied on Crea's wrongful conduct; and, that there was a sufficient causal connection between the purchasers loss and Crea's wrongful conduct.

Under the facts of this case, Crea's inadvertent failure to exercise due care, which resulted in Crea's not detecting the president's embezzlement, will not be sufficient to satisfy the scienter element because such conduct amounts merely to negligence. Therefore, Crea will not be liable for damages under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.

Crea is likely to be held liable to Safe Bank based on Crea's negligence despite the fact that Safe is not in privity of contract with Crea. In general, a CPA will not be liable for negligence to creditors if its auditor's report was primarily for the benefit of the client, for use in the development of the client's business, and only incidentally or collaterally for the use of those to whom the client might show the financial statements. However, a CPA is generally liable for ordinary negligence to third parties if the audit report is for the identified third party's primary benefit.

In order to establish Crea's negligence, Safe must show that: Crea had a legal duty to protect Safe from unreasonable risk; Crea failed to perform the audit with the due care or competence expected of members of its profession; there was a causal relationship between Safe's loss and Crea's failure to exercise due care; actual damage or loss resulting from Crea's failure to exercise due care. On the facts of this case, Crea will be liable based on negligence since the audited financial statement reports were for the primary benefit of Safe, an identified third party, and Crea failed to exercise due care in detecting the president's embezzlement, which resulted in Safe's loss, i.e., Dark's default in repaying the loan to Safe.
ANSWERS TO EXAMINATION

ACCOUNTING THEORY

(Theory of Accounts)

November 4, 1988; 1:30 to 5:00 P.M.

Answer 1 (60 points)

1. b 11. d 21. d 31. a 41. c 51. c
2. b 12. d 22. c 32. d 42. b 52. d
3. b 13. b 23. d 33. c 43. d 53. c
4. c 14. d 24. c 34. b 44. a 54. a
5. d 15. b 25. a 35. d 45. d 55. b
6. a 16. c 26. c 36. d 46. a 56. a
7. a 17. d 27. b 37. b 47. a 57. b
8. b 18. b 28. d 38. c 48. d 58. a
9. c 19. c 29. b 39. a 49. a 59. c
10. b 20. c 30. c 40. c 50. a 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 | 4 | 5 | 6 | 7 | 8 | 9 | 10| 11| 12| 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 | 21 | 22 | 23 |

| Correct | 21| 22| 23| 24| 25| 26| 27| 28| 29| 30| 31| 32| 33| 34| 35| 36| 37| 38| 39| 40|
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 24| 25| 26| 27| 28| 29| 30| 31| 32| 33| 34 | 35 | 36 | 37 | 38 | 39 | 40 | 41 | 42 | 43 |

| Correct | 41| 42| 43| 44| 45| 46| 47| 48| 49| 50| 51| 52| 53| 54| 55| 56| 57| 58| 59| 60|
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 44| 45| 46| 47| 48| 49| 50| 51| 52| 53| 54 | 55 | 56 | 57 | 58 | 59 | 60 | 60 | 60 | 60 |
Answer 2 (10 points)

a.1. Hogan should account for the sales discounts at the date of sale using the net method by recording accounts receivable and sales revenue at the amount of sales less the sales discounts available.

Revenues should be recorded at the cash equivalent price at the date of sale. Under the net method, the sale is recorded at an amount that represents the cash equivalent price at the date of exchange (sale).

2. There is no effect on Hogan's sales revenues when customers do not take the sales discounts. Hogan's net income is increased by the amount of interest (discount) earned when customers do not take the sales discounts.

b. Trade discounts are neither recorded in the accounts nor reported in the financial statements. Therefore, the amount recorded as sales revenues and accounts receivable is net of trade discounts and represents the cash equivalent price of the asset sold.

c. To account for the accounts receivable factored on August 1, 1987, Hogan should decrease accounts receivable by the amount of accounts receivable factored, increase cash by the amount received from the factor, and record a loss. Factoring of accounts receivable on a without recourse basis is equivalent to a sale. The difference between the cash received and the carrying amount of the receivables is a loss.

d. Hogan should report the face amount of the interest-bearing notes receivable and the related interest receivable for the period from October 1 through December 31 on its balance sheet as noncurrent assets. Both assets are due on September 30, 1989, which is more than one year from the date of the balance sheet.

Hogan should report interest revenue from the notes receivable on its income statement for the year ended December 31, 1987. Interest revenue is equal to the amount accrued on the notes receivable at the appropriate rate for three months.

Interest revenue is realized with the passage of time. Accordingly, interest revenue should be accounted for as an element of income over the life of the notes receivable.

Answer 3 (10 points)

a.1. The capitalized cost for the computer includes all costs reasonable and necessary to prepare it for its intended use. Examples of such costs are the cash purchase price, delivery, installation, testing, and set up.

2. The objective of depreciation accounting is to allocate the depreciable cost of an asset over its estimated useful life in a systematic and rational manner. This process matches the depreciable cost of the asset with revenues generated from its use. Depreciable cost is the capitalized cost less its estimated residual (salvage) value.

b. The rationale for using accelerated depreciation methods is based on the following assumptions:

- An asset is more productive in the earlier years of its estimated useful life. Therefore, larger depreciation charges in the earlier years would be matched against the larger revenues generated in the earlier years.
- An asset may become technologically obsolete prior to the end of its originally estimated useful life. The risk associated with estimated long-term cash flows is greater than the risk associated with near-term cash flows. Accelerated depreciation recognizes this condition.

c. Patrick should record depreciation expense to the date of disposal. Recording depreciation updates the carrying amount of the automobile. If the carrying amount of the automobile (capitalized cost less accumulated depreciation) differs from the cash proceeds from the disposal, a gain or loss results. Patrick should report gain or loss on disposal as part of income from continuing operations.
**Accounting Theory**

**Answer 4 (10 points)**

a. Skinner should report the potential costs due to the discovery of a possible product defect as an expense or loss in the income statement and as a liability in the balance sheet. In addition, Skinner should disclose the nature of the costs due to the discovery of a possible product defect.

Accrual and disclosure are required if both of the following conditions are met:

- It is considered probable that a liability has been incurred.
- The amount of loss can be reasonably estimated.

In this case both conditions are met.

b. Skinner should not report the potential claim for damages that may be received next year in the current year’s income statement or balance sheet. Gain contingencies usually are not recorded in the accounts in advance of their realization. However, adequate disclosure should be made of gain contingencies, but care should be exercised to avoid misleading implications as to the likelihood of realization.

c. This year, Skinner should account for the potential costs due to the promotion campaign as a premium expense and as a liability for 70 percent of the dollar amount of the coupons issued. The amount of the liability at the end of this year would be 30 percent of the dollar amount of the coupons issued. This amount represents 70 percent of the dollar amount of the coupons issued this year less 40 percent of the dollar amount of the coupons redeemed and for which cash refunds were sent.

**Answer 5 (10 points)**

a. A business combination accounted for as a purchase is an arms-length transaction in which one company acquires another company. The purchased company is treated as an acquired asset and is recorded at its cost to the acquiring company. Therefore, a new basis of accounting is established for the net assets of the acquired company.

2. All identifiable assets acquired and liabilities assumed in a business combination should be recorded at their fair values at date of acquisition. If the cost of the acquired company exceeds the fair value of the identifiable net assets acquired, the excess should be recorded as goodwill.

3. Goodwill should be amortized by charges to income over the periods estimated to be benefited. The period of amortization should not, however, exceed 40 years. The straight-line method of amortization should be applied unless a company demonstrates that another systematic method is more appropriate.

b. A business combination accounted for as a pooling of interests is a combination of ownership interests of previously separate companies. As a result, the existing basis of accounting continues for both companies.

2. In a pooling of interests, the carrying amount of stockholders’ equities of the separate companies are combined. Normally, the combined corporation records as contributed capital the capital stock and capital in excess of par or stated value of outstanding stock of the separate companies. Similarly, retained earnings or deficits of the separate companies are combined and recognized as retained earnings of the combined corporation.

The amount of outstanding shares of stock of the combined corporation at par or stated value may exceed the total amount of capital stock of the combining companies. The excess should be deducted first from the combined other contributed capital and then from the combined retained earnings.
SUGGESTED REFERENCES

November 1988

Accounting Practice — Part I

Numbers 1, 2 and 3


Number 5

**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**

**Number 4**

**Number 5**

N-77
Suggested References

Auditing

Number 1

AICPA, *Codification of Statements on Auditing Standards* Nos. 1 to 51 (Commerce Clearing House, 1987).
AICPA, *Codification of Statements on Standards for Accounting and Review Services* Nos. 1 to 6 (Commerce Clearing House, 1987).

Number 2

AICPA, *Codification of Statements on Auditing Standards* Nos. 1 to 51 (Commerce Clearing House, 1987), section 334.

Number 3


Number 4

AICPA, *Codification of Statements on Standards for Accounting and Review Services* Nos. 1 to 6 (Commerce Clearing House, 1987), Sections 100 and 200.

Number 5

AICPA, *Codification of Statements on Auditing Standards* Nos. 1 to 51 (Commerce Clearing House, 1987), section 326.
Suggested References

Business Law

Number 1

Causey, Duties and Liabilities of Public Accountants, rev. ed. (Dow Jones-Irwin, 1982).
Uniform Partnership Act, Sections 9, 17.

Number 2

Uniform Commercial Code. Section 2-201.

Number 3

Schantz, Commercial Law for Business and Accounting Students (West, 1980), pp. 690, 697, 836-837, 857-858.

Number 4

Uniform Partnership Act, Sections 9, 17.

Number 5

Securities Act of 1933, Regulation D, Preliminary Notes, Rule 505.
Securities Exchange Act of 1934, Section 10(b) and rule 10b-5.

N-79
Suggested References

Accounting Theory

Number 1

FASB, Accounting Standards, Current Text (FASB).
FASB, Financial Accounting Standards, Original Pronouncements (FASB).
GASB, Codification of Governmental Accounting and Financial Reporting Standards (GASB).
Griffin, Williams, Larson, Boatsman, and Bell, Advanced Accounting, 5th ed. (Irwin, 1985).
Matz and Usry, Cost Accounting: Planning and Control, 8th ed. (South-Western, 1984).

Number 2


Number 3


Number 4


Number 5

## 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.

### Accounting Practice — Content Specification Outline

#### I. Presentation of Financial Statements or Worksheets.

- A. **Balance Sheet** ...........................................4(N-22)
- B. **Income Statement** ......................................7M(N-3),8M(N-3),9M(N-3)
- C. **Statement of Changes in Financial Position** ........
- D. **Statement of Owners’ Equity** ..................
- E. **Consolidated Financial Statements or Worksheets** .....2M(N-2),3M(N-2),4M(N-2),5M(N-2),6M(N-3),5(N-12)

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

- A. **Cash, Marketable Securities, and Investments** ......1M(N-2),14M(N-4),15M(N-4)
- B. **Receivables and Accruals** ..............................10M(N-3),16M(N-4),18M(N-4)
- C. **Inventories** .............................................17M(N-4),19M(N-4)
- D. **Property, Plant, and Equipment Owned or Leased** 4(N-11)
- E. **Intangibles and Other Assets** ..........................11M(N-3),12M(N-3),23M(N-5),24M(N-5)

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

- A. **Payables and Accruals** ..................................13M(N-4),4(N-22)
- B. **Deferred Revenues** ......................................20M(N-5),21M(N-5)
- C. **Deferred Income Tax Liabilities** ..................4(N-22)
- D. **Capitalized Lease Liability** .........................22M(N-5),29M(N-6)
- E. **Bonds Payable** ..........................................39M(N-8)
- F. **Contingent Liabilities and Commitments** ...........25M(N-5),30M(N-6),32M(N-7)

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

- A. **Preferred and Common Stock** ..........................48M(N-9)
- B. **Additional Paid-in Capital** ............................28M(N-6)
- C. **Retained Earnings and Dividends** .................60M(N-10)
- D. **Treasury Stock and Other Contra Accounts** .....44M(N-8)
- E. **Stock Options, Warrants, and Rights** ...............41M(N-8)
- F. **Reorganization and Change in Entity** ..............56M(N-10)
- G. **Partnerships** ...........................................26M(N-6),27M(N-6)
Index

Accounting Practice — Content Specification Outline (cont.)

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 ........................................................ 31M(N-6), 33M(N-7), 34M(N-7), 35M(N-7), 36M(N-7), 37M(N-7), 38M(N-7), 40M(N-8), 42M(N-8)
B. Expenses and Losses ....................................................... 43M(N-8), 4(N-11), 4(N-22)
C. Provision for Income Tax .............................................. 4(N-22)
D. Recurring Versus Nonrecurring Transactions and Events ........................................... 45M(N-8), 47M(N-9)
E. Accounting Changes ........................................................ 4(N-11)
F. Earnings Per Share .......................................................... 50M(N-9), 57M(N-10)

VI. Other Financial Topics.

A. Disclosures in Notes to the Financial Statements ......51M(N-9)
B. Accounting Policies ........................................................
C. Nonmonetary Transactions ............................................. 4(N-11)
D. Interim Financial Statements ........................................... 46M(N-8)
E. Historical Cost, Constant Dollar Accounting, and Current Cost ............................................. 52M(N-9)
F. Gain Contingencies .......................................................... 53M(N-9)
G. Segments and Lines of Business ........................................
H. Employee Benefits .......................................................... 54M(N-10)
I. Analysis of Financial Statements ................................. 49M(N-9)
J. Development Stage Enterprises ................................. 55M(N-10)
K. Personal Financial Statements ................................. 59M(N-10)
L. Combined Financial Statements ................................. 58M(N-10)

VII. Cost Accumulation, Planning, and Control.

A. Nature of Cost Elements .................................................. 5(N-23)
B. Process and Job Order Costing ........................................
C. Standard Costing ............................................................
D. Joint and By-Product Costing, Spoilage, Waste, and Scrap ...........................................
E. Absorption and Variable Costing ........................................
F. Budgeting and Flexible Budgeting ....................................
G. Breakeven and Cost-Volume-Profit Analysis ..................
H. Capital Budgeting Techniques .......................................... I. Performance Analysis ..................................................
J. Other ................................................................. 5(N-23)

VIII. Not-for-Profit and Governmental Accounting.

A. Fund Accounting ..........................................................
B. Types of Funds and Fund Accounts .......................... 41M(N-19), 42M(N-19), 43M(N-19), 44M(N-20), 45M(N-20), 46M(N-20), 47M(N-20), 48M(N-20), 49M(N-20), 50M(N-20), 51M(N-21), 52M(N-21)
C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations ........
D. Various Types of Not-for-Profit and Governmental Organizations ........................................... 53M(N-21), 54M(N-21), 55M(N-21), 56M(N-21), 57M(N-21), 58M(N-21), 59M(N-22), 60M(N-22)
Index

Accounting Practice — Content Specification Outline (cont.)

IX. Federal Taxation — Individuals, Estates, and Trusts.
   B. Exclusions and Adjustments to Arrive at Adjusted Gross Income .......................................... 10M(N-16),11M(N-16)
   C. Gain or Loss on Property Transactions .................................................................................... 12M(N-16)
   D. Deductions from Adjusted Gross Income .................................................................................. 13M(N-16),14M(N-16),15M(N-16)
   E. Filing Status and Exemptions ..................................................................................................... 16M(N-16)
   F. Tax Computations and Credits ..................................................................................................
   G. Statute of Limitations ................................................................................................................
   H. Estate and Gift Taxation and Income Taxation of Estates and Trusts ........................................ 17M(N-16),18M(N-17),19M(N-17),20M(N-17)

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations.
   A. Determination of Taxable Income or Loss ............................................................................... 21M(N-17),22M(N-17),23M(N-17),24M(N-17),26M(N-18),27M(N-18),28M(N-18)
   B. Tax Computations and Credits ....................................................................................................
   C. S Corporations ............................................................................................................................. 25M(N-17)
   D. Personal Holding Companies ...................................................................................................... 29M(N-18)
   E. Accumulated Earnings Tax ......................................................................................................... 30M(N-18)
   F. Distributions ............................................................................................................................... 31M(N-18)
   G. Tax-Free Incorporation ................................................................................................................
   H. Reorganizations .......................................................................................................................... 32M(N-18)
   I. Liquidations and Dissolutions ..................................................................................................... 33M(N-18)
   J. Formation of Partnership .............................................................................................................
   K. Basis of Partner’s Interest ............................................................................................................. 34M(N-18),35M(N-18),36M(N-19)
   L. Determination of Partner’s Taxable Income and Partner’s Elections ........................................
   M. Accounting Periods of Partnership and Partners ........................................................................
   N. Partner Dealing With Own Partnership ...................................................................................... 37M(N-19)
   O. Treatment of Liabilities .................................................................................................................
   P. Distribution of Partnership Assets ................................................................................................
   Q. Termination of Partnership ..........................................................................................................
   R. Types of Organizations ................................................................................................................ 38M(N-19)
   S. Requirements for Exemption ........................................................................................................ 39M(N-19)
   T. Unrelated Business Income ........................................................................................................... 40M(N-19)

N-83
Auditing — Content Specification Outline

I. Professional Responsibilities.
   A. General Standards and Rules of Conduct ........................... 1M(N-26), 2M(N-26), 3M(N-26), 4M(N-26), 5M(N-26)
   B. Control of the Audit .......................................................... 6M(N-26), 7M(N-26), 11M(N-27), 23M(N-28), 33M(N-30)
   C. Other Responsibilities ...................................................... 9M(N-27), 10M(N-27), 12M(N-27), 15M(N-27), 30M(N-29)

II. Internal Control.
   A. Definitions and Basic Concepts ............................................. 31M(N-29), 32M(N-29), 36M(N-30)
   B. Study and Evaluation of the System ...................................... 13M(N-27), 34M(N-30), 37M(N-30), 38M(N-30), 39M(N-30), 49M(N-31)
   C. Cycles .................................................................................. 40M(N-30), 41M(N-31), 42M(N-31), 43M(N-31), 44M(N-31), 45M(N-31), 46M(N-31)
   D. Other Considerations ............................................................ 35M(N-30), 47M(N-31), 48M(N-31), 60M(N-33), 3(N-34)

III. Evidence and Procedures.
   A. Audit Evidence ................................................................. 51M(N-32), 52M(N-32), 53M(N-32), 5(N-35)
   B. Specific Audit Objectives and Procedures .............................. 54M(N-32), 55M(N-32), 56M(N-32)
   C. Other Specific Audit Topics ................................................... 8M(N-27), 57M(N-32), 59M(N-32), 2(N-34)
   D. Review and Compilation Procedures ....................................... 50M(N-32)

IV. Reporting.
   A. Reporting Standards and Types of Reports ............................ 16M(N-28), 17M(N-28), 18M(N-28), 19M(N-28),
      20M(N-28), 21M(N-28), 22M(N-28), 24M(N-29), 25M(N-29), 26M(N-29), 27M(N-29), 58M(N-32), 4(N-35)
   B. Other Reporting Considerations ........................................... 14M(N-27), 28M(N-29), 29M(N-29)
## Index

### Business Law — Content Specification Outline

#### I. The CPA and the Law.
- A. Common Law Liability to Clients and Third Persons ........................................... 5(N-46)
- B. Federal Statutory Liability ................................................................. 5(N-46)
- C. Workpapers, Privileged Communication, and Confidentiality ...

#### II. Business Organizations.
- A. Agency ......................................................................................... 1M(N-37), 2M(N-37), 3M(N-37)
- B. Partnerships and Joint Ventures ............................................ 4(N-46), 4M(N-37)
- C. Corporations .............................................................................. 3(N-45), 5M(N-37), 6M(N-37)
- D. Estates and Trusts ................................................................. 7M(N-38), 8M(N-38), 9M(N-38)

#### III. Contracts.
- A. Offer and Acceptance ................................................................. 10M(N-38), 11M(N-38), 12M(N-38)
- B. Consideration ............................................................................... 2(N-45)
- C. Capacity, Legality, and Public Policy .................................. 13M(N-38)
- D. Statute of Frauds ......................................................................... 2(N-45), 14M(N-39)
- E. Statute of Limitations .................................................................
- F. Fraud, Duress, and Undue Influence ........................................... 15M(N-39)
- G. Mistake and Misrepresentation ........................................... 16M(N-39)
- H. Parol Evidence Rule .................................................................
- I. Third Party Rights ........................................................................ 17M(N-39)
- J. Assignments .................................................................................. 18M(N-39)
- K. Discharge, Breach, and Remedies ........................................ 19M(N-39)

#### IV. Debtor-Creditor Relationships.
- A. Suretyship ..................................................................................... 20M(N-39), 21M(N-39)
- B. Bankruptcy .................................................................................... 22M(N-40), 23M(N-40), 24M(N-40), 25M(N-40), 26M(N-40), 27M(N-40), 28M(N-40), 29M(N-41)

#### V. Government Regulation of Business.
- A. Regulation of Employment .................................................. 3(N-45), 30M(N-41)
- B. Federal Securities Acts .......................................................... 31M(N-41), 32M(N-41), 33M(N-41), 34M(N-41)

#### VI. Uniform Commercial Code.
- A. Commercial Paper ........................................................................ 35M(N-41), 36M(N-42), 37M(N-42), 38M(N-42), 39M(N-42), 40M(N-42), 41M(N-42)
- B. Documents of Title and Investment Securities .................. 42M(N-42)
- C. Sales .............................................................................................. 3(N-45), 43M(N-42), 44M(N-42), 45M(N-42), 46M(N-43), 47M(N-43), 48M(N-43), 49M(N-43), 50M(N-43), 51M(N-43)
- D. Secured Transactions ..................................................................... 52M(N-43), 53M(N-44), 54M(N-44), 55M(N-44)

#### VII. Property.
- A. Real and Personal Property .................................................. 56M(N-44), 57M(N-44), 58M(N-44)
- B. Mortgages ...................................................................................... 59M(N-44), 60M(N-44)
- C. Fire and Casualty Insurance ................................................... 2(N-45)

N-85
Index

Accounting Theory — Content Specification Outline

   A. Authority of Pronouncements ........................................ 1M(N-48)
   B. Conceptual Framework .................................................. 1M(N-48)
   C. Basic Concepts and Accounting Principles ................... 2(N-54),3(N-54),4(N-55),5(N-55)
   D. Nature and Purpose of Basic Financial Statements ...... 2(N-54),3(N-54),4(N-55),5(N-55)
   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 GAAP.
   A. Cash, Marketable Securities, and Investments ............. 2M(N-48),3M(N-48),4M(N-48),5M(N-48)
   B. Receivables and Accruals ............................................. 2(N-54)
   C. Inventories .................................................................... 6M(N-48),7M(N-48),8M(N-48)
   D. Property, Plant, and Equipment Owned or Leased ....... 3(N-54)
   E. Intangibles and Other Assets ........................................... 9M(N-49)

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With GAAP.
    A. Payables and Accruals .................................................. 10M(N-49)
    B. Deferred Revenues ....................................................... 11M(N-49)
    C. Deferred Income Tax Liabilities .................................. 12M(N-49)
    D. Capitalized Lease Liability ........................................... 13M(N-49)
    E. Bonds Payable ............................................................. 14M(N-49),15M(N-49),16M(N-49)
    F. Contingent Liabilities and Commitments .................... 4(N-55)

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With GAAP.
    A. Preferred and Common Stock ....................................... 17M(N-49)
    B. Additional Paid-in Capital ............................................
    C. Retained Earnings and Dividends ................................ 18M(N-50)
    D. Treasury Stock and Other Contra Accounts ............... 19M(N-50)
    E. Stock Options, Warrants, and Rights ......................... 20M(N-50)
    F. Reorganization and Change in Entity .........................
    G. Partnerships .............................................................. 21M(N-50)

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to GAAP.
    A. Revenues and Gains .................................................... 2(N-54),3(N-54),22M(N-50),23M(N-50),24M(N-50),25M(N-50)
    B. Expenses and Losses .................................................. 2(N-54),3(N-54),4(N-55),26M(N-51),27M(N-51),28M(N-51),29M(N-51)
    C. Provision for Income Tax ............................................ 30M(N-51)
    D. Recurring Versus Nonrecurring Transactions ............ 31M(N-51)
    E. Accounting Changes ................................................... 32M(N-51)
    F. Earnings Per Share ..................................................... 33M(N-51)

N-86
VI. Other Financial Topics.

A. Statement of Changes in Financial Position ...........34M(N-51),35M(N-51)
B. Accounting Policies ........................................
C. Accounting Changes ........................................
D. Nonmonetary Transactions .................................36M(N-51)
E. Business Combinations ......................................5(N-55)
F. Interim Financial Statements ...............................37M(N-52)
G. Gain Contingencies ..........................................4(N-55)
H. Segments and Lines of Business ..........................
I. Employee Benefits ..........................................38M(N-52)
J. Analysis of Financial Statements .........................39M(N-52)
K. Development Stage Enterprises ...........................
L. Personal Financial Statements ............................40M(N-52)
M. Combined Financial Statements ...........................

VII. Cost Accumulation, Planning, and Control.

A. Nature of Cost Elements ....................................41M(N-52)
B. Process and Job Order Costing .............................42M(N-52)
C. Standard Costing ............................................43M(N-52)
D. Joint and By-Product Costing, Spoilage, Waste, and
   Scrap ............................................................44M(N-52)
E. Absorption and Variable Costing ..........................45M(N-52)
F. Budgeting and Flexible Budgeting ..........................46M(N-52)
G. Breakeven and Cost-Volume-Profit Analysis ...........47M(N-52)
H. Capital Budgeting Techniques ..............................48M(N-52)
I. Performance Analysis .......................................49M(N-53)
J. Other ....................................................................50M(N-53)

VIII. Not-for-Profit and Governmental Accounting.

A. Conceptual Framework .......................................51M(N-53)
B. Fund Accounting .............................................52M(N-53),53M(N-53)
C. Types of Funds and Fund Accounts .......................54M(N-53),55M(N-53),56M(N-53),57M(N-53)
D. Presentation of Financial Statements for Various
   Not-for-Profit and Governmental Organizations .......58M(N-53)
E. Various Types of Not-for-Profit and
   Governmental Organizations ...............................59M(N-53),60M(N-53)
CONTRIBUTORS TO THIS UNIFORM CPA EXAMINATION

The Board of Examiners expresses its gratitude to the following contributors of questions appearing in the November 1988 examination.

G. F. DOMINIAK, Texas Christian University.
RITA HULL, Virginia Commonwealth University.
KARL B. PUTNAM, University of Texas, El Paso.
RAY ROBERTS, California State University, Hayward.
ROY E. TUTTLE, University of Wisconsin, Madison.
CHARLES P. ZLATKOVICH, University of Texas, El Paso.

FUTURE CPA EXAMINATION DATES

<table>
<thead>
<tr>
<th>Year</th>
<th>May 3, 4, 5</th>
<th>November 1, 2, 3</th>
<th>May 3, 4, 5</th>
<th>November 1, 2, 3</th>
<th>May 3, 4, 5</th>
<th>November 1, 2, 3</th>
<th>May 3, 4, 5</th>
<th>November 1, 2, 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
<td>November</td>
<td></td>
</tr>
</tbody>
</table>
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 (I. 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
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
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
Content Specification Outlines

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

CSO-5
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

CSO-6
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
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
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
Content Specification Outlines

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

CSO-11
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
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

CSO-13
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
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 regulation of business, Uniform Commercial Code, and property. Many of the subjects on the examination are normally covered in standard textbooks on business law, auditing, taxation, and accounting; however, some subjects either are not included in such texts or are not covered in adequate depth. Important recent developments with which candidates are expected to be familiar may not yet be reflected in some texts. Candidates are expected to recognize the existence of legal implications and the applicable basic legal principles, and they are usually asked to indicate the probable result of the application of such basic principles.

The Business Law section is chiefly conceptual in nature and is broad in scope. It is not intended to test competence to practice law nor expertise in legal matters, but to determine that the candidates' knowledge is sufficient to (1) recognize relevant legal issues, (2) recognize the legal implications of business situations, (3) apply the underlying principles of law to accounting and auditing situations, and (4) seek legal counsel, or recommend that it be sought.

This section deals with federal and widely adopted uniform laws. Where there is no federal or appropriate uniform law on a subject, the questions are intended to test knowledge of the majority rules. Federal tax elements may be covered where appropriate in the overall context of a question.

Business Law — Content Specification Outline

I. The CPA and the Law (10 percent)

A. Common Law Liability to Clients and Third Persons
Content Specification Outlines

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

CSO-16
B. Bankruptcy
   1. Voluntary and Involuntary Bankruptcy
   2. Effects of Bankruptcy on Debtors and Creditors
   3. Reorganizations

V. Government Regulation of Business (10 percent)
   A. Regulation of Employment
      1. Federal Insurance Contributions Act
      2. Federal Unemployment Tax Act
      3. Workmen’s Compensation Acts
   B. Federal Securities Acts
      1. Securities Registration
      2. Reporting Requirements
      3. Exempt Securities and Transactions

VI. Uniform Commercial Code (25 percent)
   A. Commercial Paper
      1. Types of Negotiable Instruments
      2. Requisites for Negotiability
      3. Transfer and Negotiation
      4. Holders and Holders in Due Course
      5. Liabilities, Defenses, and Rights
      6. Discharge
   B. Documents of Title and Investment Securities
      1. Warehouse Receipts
      2. Bills of Lading
      3. Issuance, Transfer, and Registration of Securities
   C. Sales
      1. Contracts Covering Goods
      2. Warranties
      3. Product Liability
      4. Risk of Loss
      5. Performance and Obligations
      6. Remedies and Defenses
   D. Secured Transactions
      1. Attachment of Security Agreements
      2. Perfection of Security Interests
      3. Priorities
      4. Rights of Debtors, Creditors, and Third Parties

VII. Property, Estates, and Trusts (10 percent)
   A. Real and Personal Property
      1. Distinctions Between Realty and Personality
      2. Types of Ownership
      3. Lessor–Lessee
      4. Deeds, Recording, Title Defects, and Title Insurance
B. Mortgages
   1. Characteristics
   2. Recording Requirements
   3. Priorities
   4. Foreclosure

C. Administration of Estates and Trusts
D. Fire and Casualty Insurance
   1. Coinsurance
   2. Multiple Insurance Coverage
   3. Insurable Interest